

1987

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Recommended Citation

Fletcher, C.Edward III, "Privatizing Securities Disputes through the Enforcement of Arbitration Agreements" (1987). *Minnesota Law Review*. 924.

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Privatizing Securities Disputes Through The Enforcement of Arbitration Agreements

C. Edward Fletcher, III*

The judicial attitude toward arbitration clauses in contracts has been ambivalent throughout history. At least as far back as the Middle Ages, arbitration was an integral part of the dispute resolution systems of certain European civilizations, including that of England.¹ Arbitration continues to play a central role in the resolution of international disputes² and is part of the official dispute resolution systems of some countries.³ In the United States, arbitration has played a central role in resolving differences since the inception of the Republic.⁴

Notwithstanding this long history of arbitration, at one time judges showed an open hostility toward agreements to arbitrate, reasoning that such agreements were improper attempts to oust the courts of their rightful jurisdiction.⁵ Such

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1. See, e.g., Cohen & Dayton, *The New Federal Arbitration Law*, 12 VA. L. REV. 265, 266 (1926) ("The use of arbitration dates back to the earliest days of which we have historical knowledge. It furnished almost exclusively the tribunals for the settlement of business disputes in the medieval period, and in England up to Lord Mansfield's day was practically the sole remedy open to English merchants."); Miller, *Avoiding Legal Judgment: The Submission of Disputes to Arbitration in Medieval Iceland*, 28 AM. J. LEGAL HIST. 95 (1984) (describing arbitration procedures in Iceland circa A.D. 1000); Powell, *Settlement of Disputes by Arbitration in Fifteenth-Century England*, 2 LAW & HIST. REV. 21 (1984) (describing arbitration procedures in medieval England).

2. See, e.g., *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 508 (1974) (describing international contract calling for resolution of disputes by arbitration before the International Chamber of Commerce in Paris).

3. See, e.g., Macneil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303, 330-31 (1986) (describing arbitration as part of the official dispute resolution process in the People's Republic of China).

4. See, e.g., 1 THE PAPERS OF DANIEL WEBSTER—LEGAL PAPERS 322-32 (A. Konofsky & A. King eds. 1982) (describing arbitration and reference practices in New Hampshire in the early eighteenth century).

5. See, e.g., *W.H. Blodgett Co. v. Bebe Co.*, 190 Cal. 665, 667, 214 P. 38, 39 (1923) (discussing origin of rule that arbitration agreements are unenforceable as attempts to "oust the legally constituted courts of their jurisdiction and set up private tribunals"); *Cocalis v. Nazlides*, 308 Ill. 152, 159-60, 139 N.E. 95, 98-99

jurisdictional jealousy has appeared even in modern times.⁶ Despite historical judicial hostility, parties have continued to arbitrate their disputes. Today, given crowded courts and prohibitive litigation costs, arbitration is an increasingly popular alternative⁷ that has received the unqualified endorsement of former Chief Justice Warren Burger.⁸

Arbitration is a particularly popular method for resolving securities disputes. For the year ended March 31, 1984, more than 3000 securities and commodities cases were filed in federal district courts.⁹ During roughly the same period, however, almost 2000 securities cases alone were arbitrated under the auspices of the various self-regulatory organizations (SROs).¹⁰ This

(1923) (holding that an agreement to submit future disputes or controversies to arbitration was void in accordance with the common law where an arbitration statute required an existing controversy), *superseded by* ILL. ANN. STAT. ch. 10, para. 101 (Smith-Hurd 1981 & Supp. 1986) (validating written contracts to submit future disputes to arbitration) *as stated in* *Grace Ev. Luth. Church v. Lutheran Church-Missouri Synod*, 118 Ill. App. 3d 151, 158, 454 N.E.2d 1038, 1043 (1983), *cert. denied*, 469 U.S. 820 (1984); *Gauche v. Metropolitan Bldg. Co.*, 125 La. 530, 534-35, 51 So. 578, 579 (1910) (refusing to order specific performance of a contract which required defendant to appoint a disinterested party to confer with the plaintiff's appointed disinterested party as to choice of arbitrator); *Hurst v. Litchfield*, 39 N.Y. 377, 379 (1868) (stating that arbitration stipulations are regarded as against common law policy because they exclude the courts, which are the proper forums to entertain and decide legal controversies); *see also Scherk*, 417 U.S. at 510 (stating that the Federal Arbitration Act, enacted in 1924, reversed centuries of judicial hostility toward arbitration agreements).

6. *See, e.g., Shearson, Hammill & Co. v. Vouis*, 247 So. 2d 733, 735 (Fla. Dist. Ct. App.) (basing its decision on the proposition that "agreements to arbitrate controversies in the future cannot and should not oust the courts of the jurisdiction conferred on them by organic law"), *cert. denied*, 253 So. 2d 444 (Fla. 1971).

7. The number of commercial and labor cases arbitrated under the auspices of the American Arbitration Association (AAA), for example, more than doubled between 1975 and 1985. *See Meyerowitz, The Arbitration Alternative*, 71 A.B.A. J. 78, 79 (Feb. 1985) (stating that in 1985, nearly 40,000 new commercial, labor, accident, and construction cases were filed with the AAA). Robert Coulson, president of the AAA, claims that more commercial disputes are now arbitrated than tried before juries. *See id.*

8. *See Middleton, Burger: Arbitrate More and Litigate Less*, 68 A.B.A. J. 257 (Mar. 1982).

9. *See Katsoris, The Arbitration of a Public Securities Dispute*, 53 FORDHAM L. REV. 279, 279 n.5 (1984).

10. *See id.* at 280 n.7 (showing that in 1983, 1731 cases were submitted to various SROs for arbitration). These SROs are the American Stock Exchange, the New York Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the Cincinnati Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, and the National Association of Securities Dealers.

number does not include the arbitration of securities disputes before tribunals such as the New York Chamber of Commerce Arbitration Department or the American Arbitration Association.¹¹ The number of cases submitted to arbitration before those SROs has been increasing annually.¹²

Nevertheless, the increasing popularity of arbitration of securities disputes does not mean that a contractual arbitration clause will be enforced over the protestations of the other party to the contract. The enforceability of contractual arbitration clauses in securities disputes is a doctrinally complex area of law that becomes more complex and less clear every time the United States Supreme Court considers the matter. This Article sorts through the doctrinal complexity, which the recent Supreme Court case of *Dean Witter Reynolds Inc. v. Byrd*¹³ made worse, and offers recommendations for the future. Part I examines the interrelationship between the three statutes involved in determining the arbitrability of securities disputes: the Federal Arbitration Act (the FAA),¹⁴ the Securities Act of 1933 (the 1933 Act),¹⁵ and the Securities Exchange Act of 1934 (the 1934 Act).¹⁶

Part II presents the development of the case law regarding the arbitrability of securities disputes, beginning with *Wilko v. Swan*,¹⁷ through *Scherk v. Alberto-Culver Co.*,¹⁸ to the recent *Dean Witter Reynolds Inc. v. Byrd*.¹⁹ Part II demonstrates that these three cases failed to resolve several troublesome issues regarding the arbitrability of securities disputes.

Part III examines the maelstrom of controversy engendered by the three cases and the current unsettled state of the law. As Part III shows, lower courts have continued to disagree vehemently about where these three cases leave the law on is-

11. As discussed *infra* notes 355-60 and accompanying text, securities agreements between brokers and customers, if they include arbitration clauses, generally give the customer the choice of where she wants to arbitrate. Frequently, the AAA and, to a lesser extent, the New York Chamber of Commerce Arbitration Department are among the options available to the customer. *See id.*

12. In 1980, 830 cases were submitted for arbitration before those SROs; in 1981, 1,042; in 1982, 1,340; and in 1983, 1,731. *See Katsoris, supra* note 9, at 280 n.7.

13. 470 U.S. 213 (1985).

14. 9 U.S.C. §§ 1-14 (1982).

15. 15 U.S.C. §§ 77a-77aa (1982).

16. *Id.* §§ 78a-78kk.

17. 346 U.S. 427 (1953).

18. 417 U.S. 506 (1974).

19. 470 U.S. 213 (1985).

sues of arbitrability. The Supreme Court will resolve certain aspects of that disagreement soon; the Court has agreed to decide a case that raises some of the most important issues surrounding securities arbitration.²⁰

Finally, Part IV addresses the larger question of whether arbitration is an appropriate mechanism for resolving securities disputes. Part IV contends that myths are largely responsible for the general antipathy toward the arbitration of securities claims. The Article then offers guidance for the future, arguing that once the myths surrounding arbitration practices are dispelled, a clear case exists for allowing parties to avoid the expense and delay of litigation in favor of arbitration. The Article concludes by recommending increased judicial tolerance for the privatization of securities disputes and legislative changes that would foster that judicial tolerance.

I. THE STATUTORY PRONOUNCEMENTS

A. THE FEDERAL ARBITRATION ACT

1. Hostility, Costs, and Congestion

The starting point for any analysis of securities arbitration is, of course, the FAA.²¹ As noted above, the judiciary was once openly hostile to contract provisions calling for an arbitral forum for dispute resolution.²² Congress sought to change that hostility in 1925 by enacting the FAA,²³ which placed the enforceability of such agreements on a par with that of other contracts.²⁴ Congress's main concern in passing the Act was to enforce the arbitration agreements into which the parties had

20. *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44); *see infra* notes 189-92 and accompanying text.

21. *See* Brief For the Securities and Exchange Commission As Amicus Curiae Supporting Petitioners at 5, 8, *Shearson/American Express, Inc. v. McMahon*, *cert. granted*, 107 S. Ct. 60 (No. 86-44) [hereinafter SEC Amicus Brief].

22. *See supra* note 5 and accompanying text.

23. Federal Arbitration Act, ch. 213, 43 Stat. 883 (1925) (codified as amended at 9 U.S.C. §§ 1-14 (1982)).

24. *See* H.R. REP. NO. 96, 68th Cong., 1st Sess. 1-2 (1924) ("Arbitration agreements are simply matters of contract, and the effect of the bill is simply to make the contracting party live up to his agreement."); *see also* *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-11 (1974) (stating that the FAA was "to place arbitration agreements 'upon the same footing as other contracts'" (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2 (1924))); *The Anaconda v. American Sugar Ref. Co.*, 322 U.S. 42, 44 (1944) (stating that the FAA rendered the written contract provision requiring arbitration specifically enforceable).

entered.²⁵ In addition, Congress sought to help parties avoid the expense and delay of litigation.²⁶ By enacting the FAA, Congress intended to signal clearly its support of arbitration over litigation as a means of dispute resolution.²⁷

The FAA accomplishes Congress's two goals by declaring that in any maritime or interstate commerce transaction,²⁸ a written provision to arbitrate future disputes arising out of that transaction is "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."²⁹ The FAA provides that a federal district court must stay its proceeding on any issue it determines to be arbitrable, pending arbitration, on the motion of any party.³⁰ If the parties have not selected a means of appointing an arbitrator, the FAA provides one.³¹ The FAA also limits the availability of discovery in the arbitration process³² and judicial review of arbitral awards.³³ Finally, the FAA provides a mechanism for converting the arbitrator's award into a federal court judgment.³⁴

Courts unanimously recognize that the FAA represents a "strong national policy favoring the recognition of arbitration

25. See *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 219 (1985) ("The legislative history of the Act establishes that the purpose behind its passage was to ensure judicial enforcement of privately made agreements to arbitrate.").

26. See, e.g., *Scherk*, 417 U.S. at 510-11 (FAA designed "to avoid 'the costliness and delays of litigation' ") (quoting H.R. REP. NO. 96, 68th Cong., 1st Sess. 1, 2 (1924)); *Legg, Mason & Co. v. Mackall & Coe, Inc.*, 351 F. Supp. 1367, 1372 (D.D.C. 1972) ("The basic purpose of the [FAA] is to relieve the parties from costly litigation and help ease congested court dockets."); *Cohen & Dayton*, *supra* note 1, at 265 (stating that the FAA was motivated by "the unfortunate congestion of the courts and . . . the delay, expense and technicality of litigation").

27. See S. REP. NO. 536, 68th Cong., 1st Sess. 3 (1924) (discussing Congress's desire to avoid the "expense and delay" of litigation, and emphasizing the benefits of arbitration).

28. The requirement that the transaction be one in maritime or interstate commerce is discussed *infra* notes 48-51 and accompanying text.

29. 9 U.S.C. § 2 (1982).

30. *Id.* § 3.

31. *Id.* § 5.

32. See *id.* § 7 (providing the arbitrator with subpoena power). The problems of limited arbitral discovery are addressed *infra* notes 387-98 and accompanying text.

33. See 9 U.S.C. §§ 10-11 (1982) (providing limited grounds for judicial vacation or modification of awards respectively). The problem of limited judicial review of arbitral awards is discussed *infra* notes 402-20 and accompanying text.

34. See 9 U.S.C. § 9 (1982).

agreements as a means of resolving private conflicts short of the more costly and disruptive avenue of litigation."³⁵ Because of this strong national policy, courts construe arbitration clauses to permit arbitration of the issue presented for adjudication whenever possible.³⁶ Any doubts concerning the arbitrability of an issue, including analytical doubts arising from the lack of clarity in the statutes, must, as a matter of federal law, be resolved in favor of arbitration.³⁷ Thus, for example, when a party concedes that an issue is within the scope of the arbitration clause but claims that the arbitration clause is itself unenforceable, any doubts concerning the enforceability of the clause must be resolved in favor of arbitration.³⁸

2. Federalism and the FAA

Not every state subscribes to the federal government's liberal view of arbitration clauses.³⁹ Some states are hostile toward arbitration clauses in general;⁴⁰ others are more selective

35. *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 833 (7th Cir. 1977). See *Seaboard Coast Line R.R. v. Trailer Train Co.*, 690 F.2d 1343, 1348 (11th Cir. 1982); *Stateside Mach. Co. v. Alperin*, 591 F.2d 234, 240 (3d Cir. 1979); *DeCosta v. Columbia Broadcasting Sys.*, 520 F.2d 499, 505 (1st Cir. 1975), *cert. denied*, 423 U.S. 1073 (1976).

36. See, e.g., *Wick v. Atlantic Marine, Inc.*, 605 F.2d 166, 168 (5th Cir. 1979) ("[U]nless it can be said with positive assurance that an arbitration clause is not susceptible of an interpretation which would cover the dispute at issue, then a stay pending arbitration should be granted."); see also *Southwest Indus. Import & Export, Inc. v. Wilmod Co.*, 524 F.2d 468, 470 (5th Cir. 1975) (courts should give full effect to arbitration clauses to effectuate the intent of the parties and to ease court congestion); *Galt v. Libbey-Owens-Ford Glass Co.*, 376 F.2d 711, 714 (7th Cir. 1967) (arbitration clauses should be construed, whenever possible, in favor of arbitration); *Lundgren v. Freeman*, 307 F.2d 104, 111 (9th Cir. 1962) (same).

37. See, e.g., *Liskey v. Oppenheimer & Co.*, 717 F.2d 314, 320 (6th Cir. 1983) (federal securities case involving pendent state claim under Michigan Uniform Securities Act decided in favor of arbitration under federal law). Where the FAA applies, the party seeking to avoid arbitration has the burden of establishing that the FAA mandate is overridden. See SEC Amicus Brief, *supra* note 21, at 8-9.

38. See, e.g., *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 216-24 (1985) (where state law based issue was within arbitration clause but was raised pendent to a federal claim, plaintiff allowed to compel arbitration of the state law based claims); *Galt*, 376 F.2d at 714 (arbitration clauses should be construed in favor of arbitration).

39. This is true notwithstanding the fact that 43 states, Puerto Rico, and the District of Columbia have statutes providing for enforcement of arbitration clauses. Meyerowitz, *supra* note 7, at 79.

40. See, e.g., *Shearson, Hammill & Co. v. Vouis*, 247 So. 2d 733, 735 (Fla. Dist. Ct. App.) (refusing to oust the lower court of its jurisdiction by allowing

about which arbitration clauses they void.⁴¹ Because of this occasional state hostility to arbitration clauses, issues of federalism arise when a party seeks to enforce such a clause in state court⁴² or when a party seeks enforcement of an arbitration clause with respect to a claim under state common law⁴³ or a state statute.⁴⁴ These issues are important in securities cases both because the 1933 Act may be enforced in state courts⁴⁵ and because many federal securities cases involve pendent claims under state common law⁴⁶ or state blue sky laws.⁴⁷

Not surprisingly, the federal government generally wins these interjurisdictional battles. For the FAA to apply, the dispute must involve a maritime transaction or a transaction in commerce.⁴⁸ The FAA broadly defines "commerce" to include essentially all interstate and international commerce.⁴⁹

arbitration despite a statute providing an exception to the settled presumption against arbitration.), *cert. denied*, 253 So. 2d 444 (Fla. 1971).

41. *See, e.g., Kroog v. Mait*, 712 F.2d 1148, 1149 (7th Cir. 1983) (state securities statute purported to render void an arbitration clause in a broker-customer agreement), *cert. denied*, 465 U.S. 1007 (1984); *Keating v. Superior Court*, 31 Cal. 3d 584, 595-99, 645 P.2d 1192, 1198-1200, 183 Cal. Rptr. 360, 366-68 (1982) (California franchise statute renders void an arbitration clause in a franchise agreement), *rev'd sub nom. Southland Corp. v. Keating*, 465 U.S. 1 (1984).

42. *See, e.g., Keating*, 465 U.S. 1, 6-9 (1985) (holding that the federal court's failure to review the state court's decision on arbitration might seriously erode federal policy).

43. *See, e.g., Kavit v. A.L. Stamm & Co.*, 491 F.2d 1176, 1178 (2d Cir. 1974) (holding that state claims which would have gone to arbitration by agreement under state common law should not be joined to weak federal claims brought under the Securities Act because pendent jurisdiction would burden federal courts and the state courts are better able to decide issues of state common law); *Barbi v. W.E. Hutton & Co.*, 53 A.D.2d 562, 563, 384 N.Y.S.2d 828, 829 (1976) (upholding agreement to arbitrate in action brought under state common law rather than under 1933 Act).

44. *See, e.g., Liskey v. Oppenheimer & Co.*, 717 F.2d 314, 315 (6th Cir. 1983) (seeking arbitration for claims alleging violations of the Michigan Uniform Securities Act as well as violations of the stock exchange's and association's rules).

45. *See* 15 U.S.C. §§ 77k, 77l (1982) (permitting suits to be brought in any competent jurisdiction).

46. *See, e.g., Kavit*, 491 F.2d at 1178 (client sued stock broker for alleged 1934 Act violation and asserted claims of negligence and conversion under the pendent jurisdiction doctrine).

47. *See, e.g., Liskey*, 717 F.2d at 321 (federal securities case involving pendent state claim under Michigan's Uniform Securities Act).

48. *See* 9 U.S.C. § 2 (1982); *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 200-01 (1956).

49. *See* 9 U.S.C. § 1 (1982), which states:

"[C]ommerce", as herein defined, means commerce among the several States or with foreign nations, or in any Territory of the United

Although purely intrastate transactions are governed exclusively by state law,⁵⁰ the FAA is nevertheless fully applicable in state courts to all interstate or maritime transactions, regardless of whether the claim being asserted arises under federal or state law.⁵¹ If the arbitration clause at issue would be enforceable under the FAA, state antiarbitration statutes or antiarbitration common-law doctrines are deemed inapplicable under the supremacy clause⁵² and the issue of arbitrability is decided as a matter of federal law.⁵³

3. Applying the FAA to Securities Disputes

Securities cases in federal court often include pendent claims for violations of state common law or state securities statutes,⁵⁴ primarily because punitive damages generally are not available for claims under either the 1933 Act⁵⁵ or the 1934

States or in the District of Columbia, or between any such Territory and another, or between any such Territory and any State or foreign nation, or between the District of Columbia and any State or Territory or foreign nation, but nothing herein contained shall apply to contracts of employment of seamen, railroad employees, or any other class of workers engaged in foreign or interstate commerce.

50. See *Bernhardt*, 350 U.S. at 200-01, 203; *Conley v. San Carlo Opera Co.*, 163 F.2d 310 (1947).

51. See *Southland Corp. v. Keating*, 465 U.S. 1, 10-14 (1984).

52. *Id.*; *Kroog v. Mait*, 712 F.2d 1148, 1152-54 (1983), *cert. denied*, 465 U.S. 1007 (1984).

53. *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 638 n.8 (5th Cir. 1977); see, e.g., *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1212 (2d Cir.) (issue of arbitrability, as a question of "interpretation and construction," is governed by federal law), *cert. denied*, 406 U.S. 949 (1972); *Metro Indus. Painting Corp. v. Terminal Constr. Co.*, 287 F.2d 382, 385 (2d Cir. 1961) (same).

54. See, e.g., *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 832 (7th Cir. 1977) (investor brought suit against brokerage firm, alleging violation of 1933 Act and raising pendent state claims based on fraud and deceit, and breach of contract); *Wise v. Kidder Peabody & Co.*, 596 F. Supp. 1391, 1397-98 (D. Del. 1984) (denying arbitration where federal and state claims arose from a single recitation of facts); *Cunningham v. Dean Witter Reynolds Inc.*, 550 F. Supp. 578, 578-79 (E.D. Cal. 1982) (plaintiff alleged violations of the 1934 Act and brought pendent state claims in fraud, breach of fiduciary duty, negligent misrepresentation, and intentional infliction of emotional distress); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 266 (W.D. Tex. 1974) (action against broker alleging violations of the 1934 Act, the N.Y.S.E. rules and the Texas Securities Act).

55. See, e.g., *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1283-86 (2d Cir. 1969) (punitive damages not available in implied right of action under § 17(a) of the 1933 Act), *cert. denied*, 397 U.S. 913 (1970); *Avern Trust v. Clarke*, 415 F.2d 1238, 1242 (7th Cir. 1969) (no punitive damages under § 12(2) of the 1933 Act); *Shaefer v. First Nat'l Bank*, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970) (same), *appeal dismissed*, 463 F.2d 234 (7th Cir. 1972).

Act⁵⁶ but may be available for state claims.⁵⁷ Given the pervasive way in which federal law has gobbled up the enforcement of arbitration clauses, the question arises whether state arbitration laws, some of which declare void agreements to arbitrate state securities claims, apply at all to securities disputes. Although some of the case law says no, the better reasoned authority says yes.

In *Coenen v. R.W. Pressprich & Co.*,⁵⁸ the United States Court of Appeals for the Second Circuit seemed to indicate that any sale of securities would constitute commerce within the meaning of the FAA and thereby call into effect the pervasive federal regulation of arbitration agreements relating to such sales.⁵⁹ *Coenen* involved the private placement sale of a large block of stock.⁶⁰ Neither the appellate court's nor the district court's opinion indicated that the sale of stock involved any incidents of interstate or international commerce.⁶¹ Nonetheless, the Second Circuit stated cavalierly that "[t]he sale of securities here constitutes a transaction relating to commerce for the purposes of the Arbitration Act."⁶²

If the Second Circuit in *Coenen* meant that a sale of securities is necessarily a transaction in interstate commerce for purposes of the FAA, the statement is difficult to justify. Certainly a securities transaction can be limited to one state, especially in

56. See, e.g., *Straub v. Vaisman & Co.*, 540 F.2d 591, 599 (3d Cir. 1976) (no punitive damages under §§ 10(b), 28(a) of the 1934 Act in Rule 10b-5 cases); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 781 (3d Cir. 1976) (no punitive damages under § 14(a) of the 1934 Act); *Green v. Wolf Corp.*, 406 F.2d 291, 302 (2d Cir. 1968) (same), *cert. denied*, 395 U.S. 977 (1969).

57. See, e.g., *Flaks v. Koegel*, 504 F.2d 702, 706-07 (2d Cir. 1974) (finding that although punitive damages are not available under either the 1933 or 1934 Acts, they are permissible on pendent claims of common-law fraud). For discussion of the availability of punitive damages under state and federal securities laws, see generally Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims*, 29 DE PAUL L. REV. 693, 709 (1980) (noting that state law claims are often included in federal securities complaints to make recovery of punitive damages possible); Note, *The Severability of Arbitrable and Nonarbitrable Securities Claims*, 41 WASH. & LEE L. REV. 1165, 1167 ("The possibility of recovering punitive damages is a primary reason that investors plead state-based causes of action."); Comment, *Punitive Damages and the Federal Securities Act: Recovery Via Pendent Jurisdiction*, 47 MISS. L.J. 743 (1976); Comment, *The Reappearance of Punitive Damages in Private Actions for Securities Fraud*, 5 TEX. TECH L. REV. 111 (1973).

58. 453 F.2d 1209 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972).

59. See *supra* text accompanying notes 48-53.

60. See *Coenen*, 453 F.2d at 1210.

61. See *id.* at 1211, *aff'g* 329 F. Supp. 1296 (S.D.N.Y. 1971).

62. See *id.*

the case of a private placement, where no national securities exchange is involved. That fact was recognized in a more thoughtful opinion by Judge Charles M. Metzner of the United States District Court for the Southern District of New York in 1967. In *Pawgan v. Silverstein*,⁶³ Judge Metzner held that the FAA does not apply to claims under state securities acts when the transactions at issue have no interstate elements.⁶⁴ Judge Metzner noted that the matter is a bit confusing, because the federal securities laws can apply to such intrastate transactions if the transactions involve the use of instrumentalities of interstate commerce.⁶⁵ In other words, one can use means of interstate commerce like a telephone or the mail, thereby calling into play the federal securities laws, and still have the transaction be entirely intrastate for commerce purposes under the FAA. Because of the long-distance nature of most modern securities transactions, however, the commerce provisions of the FAA will almost always render state arbitration statutes inapplicable to securities disputes. Nonetheless, given the proper set of facts, the courts should apply certain state common-law doctrines and statutes relating to arbitration.

B. THE ANTIWAIVER PROVISIONS OF THE 1933 AND 1934 ACTS

Absent other strong federal policies, the FAA would mandate enforcement of all arbitration clauses involved in interstate or international transactions, as long as basic contract principles did not create enforcement problems.⁶⁶ As the Supreme Court said recently, "The preeminent concern of Congress in passing the [Federal Arbitration] Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate . . . at least absent a countervailing policy manifested in another federal statute."⁶⁷

The antiwaiver provisions contained in the 1933 and 1934 Acts arguably manifest such a countervailing policy.⁶⁸ In the early twentieth century, the common law seemed to permit a

63. 265 F. Supp. 898 (S.D.N.Y. 1967).

64. *See id.* at 901.

65. *See id.*; *see also* *Loveridge v. Dreagoux*, 678 F.2d 870, 873-74 (10th Cir. 1982) (intrastate telephone call is sufficient to invoke federal securities laws).

66. *See supra* text accompanying note 29.

67. *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985).

68. The Securities and Exchange Commission (SEC) recently pointed out that the FAA can be overridden by contrary legislation, including securities legislation. *See* SEC Amicus Brief, *supra* note 21, at 8.

party to waive his right to complain of statutory securities violations by the other party, at least if such a waiver clause was not too misleading or tricky.⁶⁹ Thus, the investor could, at the outset of a transaction or relationship with his broker, absolve the other party of all statutory liability for the other party's future acts. In passing securities legislation, Congress consistently voided such predispute waivers.⁷⁰ Section 14 of the 1933 Act, which is universally recognized as being substantially identical to section 29(a) of the 1934 Act,⁷¹ is typical.⁷² "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."⁷³ Section 14 of the 1933 Act and section 29(a) of the 1934 Act mean precisely what they say: a predispute agreement to waive substantive liability is void.⁷⁴

69. See *Cacket v. Keswick* [1902] 2 Ch. 456, 476 (Ch. App.); *Greenwood v. Leather Shod Wheel Co.*, [1900] 1 Ch. 421, 435-38 (Ch. App.) (1899); L. LOSS, *FUNDAMENTALS OF SECURITIES REGULATION* 1189 (1983).

70. See Securities Act of 1933, § 14, 15 U.S.C. § 77n (1982); Trust Indenture Act of 1939, § 327, 15 U.S.C. § 77aaaa (1982); Securities Exchange Act of 1934, § 29, 15 U.S.C. § 78cc(a) (1982); Public Utility Holding Act of 1935, § 26, 15 U.S.C. § 79z (1982); Investment Advisors Act of 1940, § 215, 15 U.S.C. § 80b-15(a) (1982). England has also prohibited such waivers. See Companies Act of 1948, 11 & 12 Geo. VI, ch. 38 §§ 38(2), 47(5), 417(2). The ability of a party to waive liability for matured disputes is discussed *infra* notes 193-216 and accompanying text.

71. See *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 224-25 (1985) (White, J., concurring); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 514 n.7 (1974); Annotation, *Construction and Application of § 14 of Securities Act of 1933 (15 USCS § 77n) and § 29(a) of Securities Exchange Act of 1934 (15 USCS § 78cc(a))*, *Voiding Waiver of Compliance With Statutory Provisions or Rules or Regulations*, 26 A.L.R. FED. 495, 498 (1976).

72. There is a substantive difference between the antiwaiver provisions of the 1933 and 1934 Acts on the one hand and the antiwaiver provisions of the other securities laws on the other: all except the 1933 and 1934 Acts prohibit waivers of compliance with orders of the SEC.

73. 15 U.S.C. § 77n (1982).

74. See, e.g., *Goodman v. Epstein*, 582 F.2d 388, 402 (7th Cir. 1978) (noting the accepted rule that § 29(a) of the 1934 Act mandates that a release of claims under federal securities laws is only valid as to "mature, ripened claims of which the releasing party had knowledge before signing the release"); *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966) (viewing contractual acknowledgment of nonreliance as an agreement to waive substantive liability under § 29(a) of the 1934 Act); *Schine v. Schine*, 254 F. Supp. 986, 988 (S.D.N.Y.) (suggesting that a promise not to sue for fraud, if incorporated into the transaction to which the promise applies, is void under § 14 of the 1933 Act and § 29(a) of the 1934 Act), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1966); Annotation, *supra* note 71, at 499; cf. *Foreman v. Holsman*, 10 Ill. 2d 551, 554-55, 141 N.E.2d 31, 32-33 (1957) (clause in stock purchase contract purporting to waive future claims under Illinois securities statute is void).

Section 14, however, means more than what it seems to say, and this judicially discovered meaning creates problems for arbitration clauses. Because the 1933 Act provides a plaintiff with a multitude of judicial forums in which to assert her claim, the United States Supreme Court in *Wilko v. Swan*⁷⁵ held that a contractual clause calling for arbitration of future disputes was void to the extent that it would force arbitration of a claim under the express liability provisions of section 12(2) of the 1933 Act.⁷⁶ The *Wilko* decision is the root of the confusion that has enshrouded this area of the law for more than thirty years.

II. A PROGRESSION OF CONFUSION—*WILKO* TO *SCHERK* TO *BYRD*

A. ORIGINS OF THE *WILKO* DOCTRINE

The plaintiff in *Wilko* alleged that he was induced by the defendants, his stockbrokers, to purchase 1600 shares of stock in Air Associates, Inc.⁷⁷ through false representations made in violation of section 12(2) of the 1933 Act.⁷⁸ The plaintiff's margin agreement with the defendants provided that all future disputes arising out of the parties' relationship would be submitted to arbitration before the New York Chamber of Commerce Arbitration Committee, the American Arbitration Association, or the New York Stock Exchange Arbitration Committee, giving the plaintiff the right to elect any one of the three.⁷⁹ The defendants moved for a stay, pending arbitration, under section 3 of the FAA.⁸⁰ The district court denied the stay, and the Court

75. 346 U.S. 427 (1953).

76. *Id.* at 434-35.

77. *Id.* at 428-29.

78. Section 12 provides:

Any person who . . . (2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him

Securities Act of 1933, § 12(2), 15 U.S.C. § 77l (1982).

79. *Wilko*, 346 U.S. at 432 n.15.

80. *Id.* at 429 (citing 9 U.S.C. § 3 (Supp. V 1952)) (current version at 9 U.S.C. § 3 (1982)).

of Appeals for the Second Circuit reversed.⁸¹ In a seven to two decision, the Supreme Court held that the arbitration agreement was void under section 14 of the 1933 Act and reversed the decision of the Second Circuit.⁸²

The Court, in an opinion by Justice Reed, stated two reasons for the *Wilko* decision. First, it relied on three sections of the 1933 Act. Section 12(2), the Court noted, created a special right nonexistent at common law whereby a purchaser of securities could recover for misrepresentations without proving scienter. Section 12(2) shifted the burden of proving lack of scienter to the seller.⁸³ The Court noted that Congress created the special right as part of an investor protection scheme, which added "let the seller also beware" to the familiar maxim of caveat emptor.⁸⁴ The Court further noted that section 22 of the 1933 Act⁸⁵ provides the plaintiff the option of suing in state or federal court, does not permit the defendant to remove, and allows for nationwide service of process.⁸⁶ Finally, the Court interpreted section 14 to void all waivers of the statutory protections of the 1933 Act.⁸⁷ The majority held that a party's attempt to waive the forum choices afforded by section 22 constituted an impermissible surrender of statutory protections under section 14.⁸⁸

Although it is unclear to what extent the Court's further discussion contributed to the rationale of the decision,⁸⁹ the Court went on to state that arbitration affords less protection to

81. *Wilko v. Swan*, 201 F.2d 439 (2d Cir. 1953), *rev'g* 107 F. Supp. 75 (S.D.N.Y. 1952), *rev'd*, 346 U.S. 427 (1953).

82. *Wilko*, 346 U.S. at 438.

83. *Id.* at 431.

84. *Id.* at 430-31.

85. 15 U.S.C. § 77v(a) (1982).

86. *Wilko*, 346 U.S. at 431. The Court also added that if a suit is brought in federal court, the purchaser has a wide choice of venue, and the jurisdictional amount in controversy requirement (then \$3000, currently \$10,000) is inapplicable.

87. *Id.* at 434-35.

88. *Id.* One court has recently concluded that a party may be compelled to honor his forum-selection clause in a 1933 Act dispute if he is a sophisticated investor. *See Friedman v. World Transp., Inc.*, 636 F. Supp. 685, 690-91 (N.D. Ill. 1986). The subject of sophisticated investors and the different rules that may apply to them is examined *infra* notes 234-53 and accompanying text.

89. The SEC recently argued that the perceived lack of protection afforded by arbitration formed the basis of the *Wilko* Court's holding. SEC Amicus Brief, *supra* note 21, at 10-11. The SEC also argued that arbitration subject to the SEC's regulations provides parties' adequate protection of their rights. *Id.* at 12-21.

a claimant than judicial adjudication in three respects.⁹⁰ First, arbitrators receive no instruction on the law from a judge.⁹¹ Second, although an arbitrator must follow the law and not just "considerations of fairness," it is impossible to review an arbitrator's application of the law because no reasons are given for arbitral decisions.⁹² Third, the power to vacate an arbitral award is limited because a party must show more than mere incorrect interpretation of the law; a party must show a manifest disregard of the law.⁹³

Justice Frankfurter, joined by Justice Minton, dissented. He argued that nothing in the record of the case indicated that arbitration would not protect the claimant's rights. The record did not indicate that Wilko had no choice but to accept the arbitration clause. Finally, Justice Frankfurter also noted that arbitrators are bound by the law such that if they misapply it, the award can be vacated.⁹⁴

The *Wilko* decision has been lauded generally by commentators.⁹⁵ Indeed, Professor Louis Loss has codified its holding, with some notable exceptions, as part of the Federal Securities Code.⁹⁶ As a matter of statutory construction, however, the decision is difficult to justify. As the Court suggested, section 14 does not prohibit a party from waiving important rights established by the 1933 Act.⁹⁷ Rather, section 14 prevents one party from releasing another party from the duty of "*compliance* with any provision of this subchapter."⁹⁸ In other words, an investor cannot release ab initio a broker from that broker's duty to comply with the substantive mandates of the 1933 Act. To

90. The soundness of these and other arguments concerning the merits of arbitration procedures is discussed *infra* notes 361-420 and accompanying text.

91. *Wilko*, 346 U.S. at 436.

92. *Id.* at 433-34, 436.

93. *Id.* at 436-37.

94. *Id.* at 439-40 (Frankfurter, J., dissenting). The soundness of the dissenters' arguments supporting enforcement of arbitration clauses is discussed *infra* notes 336-420 and accompanying text.

95. See, e.g., L. LOSS, *supra* note 69, at 1193 (stating that result was "eminently sensible"); Sterk, *Enforceability of Agreements to Arbitrate: An Examination of the Public Policy Defense*, 2 CARDOZO L. REV. 481, 521 (1981) (suggesting that the *Wilko* doctrine is a good blanket rule).

96. See 2 FEDERAL SECURITIES CODE § 1725 (1980). The Code's version of the *Wilko* doctrine includes the so-called "sophisticated investor" exception, discussed *infra* notes 234-53 and accompanying text, as well as other exceptions to the general rule espoused by the Court in *Wilko*. See 2 FEDERAL SECURITIES CODE § 1725(b)(3)(C). Professor Louis Loss was the American Law Institute reporter for the Federal Securities Code.

97. *Wilko*, 346 U.S. at 434-35.

98. 15 U.S.C. § 77n (1982) (emphasis added).

read section 14 as prohibiting a claimant from agreeing to a forum change, however, even assuming that by agreeing the claimant would be giving up important rights, is to read more into the section than Congress put there.

Furthermore, the Court's reading of section 14 would seem to void all agreements to settle disputes under section 12(2). If section 14 means that a party cannot waive, even knowingly and voluntarily, his right to sue in federal court, he cannot do so in settlement of a claim. In a brief concurring opinion, Justice Jackson attempted to distinguish between predispute agreements and agreements with respect to existing claims,⁹⁹ and subsequent courts have read *Wilko* to support such a distinction.¹⁰⁰ As a logical matter, however, the distinction is impossible to maintain under the Court's interpretation of section 14.¹⁰¹

To the extent the *Wilko* majority's discussion of the perceived problems of arbitration formed any basis for the Court's decision, the majority's analysis is fundamentally flawed because that argument proves too much. If arbitration is inferior to litigation in the protection of substantive rights, that argument could serve as a basis for prohibiting the enforcement of any arbitration clause.¹⁰² Nevertheless, Congress made the policy decision in enacting the FAA that the tradeoff of judicial protection for decreased time, expense, and court congestion is a good one that parties are entitled to make.¹⁰³ Courts are not free to second-guess Congress on such matters of policy.

The basic holding of *Wilko* has remained intact and largely unchallenged for more than thirty years. Moreover, for years some courts incorrectly reasoned that it was impossible to distinguish, for purposes of gauging the enforceability of arbitration clauses, implied causes of action under the 1934 Act from the express cause of action under section 12(2) of the 1933 Act involved in *Wilko*.¹⁰⁴ Nonetheless, the Securities and Ex-

99. *Wilko*, 346 U.S. at 438 (Jackson, J., concurring).

100. See *infra* note 193 and accompanying text.

101. See *infra* text accompanying notes 206-10.

102. See, e.g., *In re Revenue Prop. Litig. Cases*, 451 F.2d 310, 313-14 (1st Cir. 1971); *Fallick v. Kehr*, 369 F.2d 899, 903 (2d Cir. 1966); cf. *Sterk*, *supra* note 95, at 516 (noting that despite the possibility that an arbitrator will misapply the law, and that the nature of arbitration usually insulates such errors from judicial review, "[s]o long as both the arbitrator and the underlying law are working to achieve justice between the parties, the risk of error is not, and should not be, particularly disturbing").

103. See *supra* notes 21-38 and accompanying text.

104. See, e.g., *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 614-15 (7th Cir.

change Commission (SEC) has recently argued that *Wilko* should be overruled¹⁰⁵ and courts, including the Supreme Court, have begun to carve away at the *Wilko* doctrine, primarily by limiting the holding of *Wilko* to its facts.¹⁰⁶ The Supreme Court's first opportunity to do so came in 1974 in *Scherk v. Alberto-Culver Co.*¹⁰⁷

B. *SCHERK* AND THE CIRCUMSCRIPTION OF
THE *WILKO* DOCTRINE

Scherk is most commonly acknowledged as standing for the proposition that international securities transactions are not subject to the *Wilko* limitation on the enforceability of arbitration clauses.¹⁰⁸ The case, however, stands for much more than that.

The parties in *Scherk* were the Alberto-Culver Company, a large American home products manufacturer, and Fritz Scherk, a German citizen and the owner of several enterprises doing business throughout Europe.¹⁰⁹ In the late 1960s, Alberto-Culver entered into negotiations with Scherk for the purchase of Scherk's businesses. Negotiations stretched over two years and took place in both Europe and the United States. The parties eventually signed an agreement in Austria for the sale of the businesses.¹¹⁰ The agreement contained an arbitration clause which provided that future disputes be adjudicated under the auspices of the International Chamber of Commerce in Paris.¹¹¹

A few months after the deal was closed, Alberto-Culver

1973), *rev'd*, 417 U.S. 506 (1974); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423, 428-29 (S.D.N.Y. 1967); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 220 (S.D.N.Y. 1965); *Reader v. Hirsch & Co.*, 197 F. Supp. 111, 114-15 (S.D.N.Y. 1961). In fact, at least one court has incorrectly stated that the Supreme Court held in *Wilko* that agreements to arbitrate claims under the 1934 Act were void. *See Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21, 27-28 (E.D. Cal. 1974).

105. SEC Amicus Brief, *supra* note 21, at 12-21.

106. The various exceptions to the *Wilko* doctrine generated by lower courts are discussed *infra* text accompanying notes 193-253.

107. 417 U.S. 506 (1974).

108. *See, e.g., Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977).

109. *Scherk*, 417 U.S. at 508.

110. *Id.*

111. *Id.* The contract also provided that "[t]he laws of the State of Illinois, U.S.A. shall apply to and govern this agreement, its interpretation and performance." *Id.*

discovered that Scherk had apparently misrepresented the status of certain trademark rights. Alberto-Culver attempted to rescind the sale on the basis of the alleged misrepresentations, but Scherk refused. Following the refusal, Alberto-Culver brought suit against Scherk in federal district court, alleging a violation of Rule 10b-5.¹¹²

Scherk moved for a stay pending arbitration as contemplated by the agreement. Alberto-Culver opposed the stay and sought a preliminary injunction against the arbitration proceedings.¹¹³ The district court denied Scherk's stay and granted Alberto-Culver's injunction, and the United States Court of Appeals for the Seventh Circuit affirmed.¹¹⁴ Both courts relied on *Wilko*,¹¹⁵ even though *Wilko* was an individual investor basing his claim on the express liability provisions of the 1933 Act¹¹⁶ and Alberto-Culver was a large corporation asserting its claim under the theory of implied causes of action for violations of Rule 10b-5, which was promulgated under the 1934 Act.¹¹⁷

In a five to four decision, the Supreme Court reversed, holding that *Wilko* was inapplicable.¹¹⁸ The Court, in a majority opinion by Justice Stewart, presented two bases for the conclusion that the arbitration clause should be enforced. First, the Court stated that "a colorable argument could be made that even the semantic reasoning of the *Wilko* opinion does not con-

112. The SEC promulgated Rule 10b-5 pursuant to the authority granted by § 10(b) of the 1934 Act, ch. 404, 48 Stat. 881, 891 (1934) (codified as amended at 15 U.S.C. § 78j(b) (1982)). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1986). Congress provided no private cause of action for violations of § 10(b) or the rules promulgated thereunder, but the courts have fashioned a private cause of action. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971).

113. *Scherk*, 417 U.S. at 509-10.

114. *Alberto-Culver Co. v. Scherk*, 484 F.2d 611 (7th Cir. 1973) *rev'd*, 417 U.S. 506 (1974).

115. See *id.* at 614.

116. See *supra* note 78 and accompanying text.

117. *Scherk*, 417 U.S. at 509.

118. *Id.* at 515-17.

trol the case before us.”¹¹⁹ The majority distinguished suits under the express liability provisions of section 12(2) of the 1933 Act from suits based on judicially created causes of action under the 1934 Act. It noted that the *Wilko* Court had made much of Congress’s creation in the 1933 Act of a “special right” for investors, not available at common law, to sue for misrepresentations without having to prove scienter. Congress provided no such special right in the 1934 Act.¹²⁰ Although both acts contain essentially identical antiwaiver provisions,¹²¹ the Court also noted that only the 1933 Act contains all the procedural rights—most importantly, broad forum-selection options—that the Court in *Wilko* said could not be waived.¹²² Thus, the *Scherk* Court expressed its belief that implied causes of action under the 1934 Act are distinct from express causes of action under section 12(2) of the 1933 Act. That view now commands a clear majority of the Justices that make up the present Supreme Court.¹²³

The Court in *Scherk* expressed a second rationale on which to distinguish *Wilko*, and it was this second distinction that the Court found “crucial.”¹²⁴ Emphasizing the importance of comity between nations and the importance of fostering certainty in international trade,¹²⁵ the Court noted an important difference between the agreements in *Wilko* and *Scherk*: “Alberto-Culver’s contract to purchase the business entities belonging to *Scherk* was a truly international agreement.”¹²⁶

The majority opinion also proffered some general thoughts about arbitration clauses, apparently in response to the dissenters’ argument that the “loss of the proper judicial forum carries with it the loss of substantial rights.”¹²⁷ Severely circumscribing the *Wilko* Court’s squeamishness about arbitration proceedings, the majority stated that the Court had previously noted that forum-selection clauses in contracts generally should be upheld absent strong reasons to the contrary, and that an arbitration clause is simply a specialized forum-selection clause that

119. *Id.* at 513.

120. *Id.* at 513-14.

121. *See id.* at 514 n.7 (stating that the differences in the two antiwaiver provisions “seem irrelevant to the issue presented in this case”).

122. *Id.* at 514.

123. *See infra* text accompanying notes 134-37.

124. *Scherk*, 417 U.S. at 515.

125. *Id.* at 515-18.

126. *Id.* at 515.

127. *Id.* at 532 (Douglas, J., dissenting).

provides both the situs and the procedure for resolving the dispute.¹²⁸

Then followed perhaps the most important portion of the opinion: "*For all these reasons* we hold that the agreement of the parties in this case to arbitrate any dispute arising out of their international commercial transaction is to be respected and enforced"¹²⁹ Notwithstanding the Court's statement that the international aspect of the case was crucial, this statement of the Court's holding makes clear that the Court also relied on the distinction it found between implied causes of actions under the 1934 Act and express actions under the 1933 Act. In other words, the Court's reasoning regarding that distinction was a basis for the holding, not obiter dictum. The point is an important one and most courts that have interpreted *Scherk* have missed or ignored it.¹³⁰

The *Scherk* Court refused to resolve several additional issues raised by the parties. *Scherk* had urged the Court to limit *Wilko*'s holding to cases in which the party seeking to avoid the arbitration clause was not in a position of equal bargaining power with the party who imposed the arbitration clause on him.¹³¹ This so-called "sophisticated investor" exception to the *Wilko* doctrine has gained credence over time and has much merit.¹³² The Court in *Scherk* expressly declined to consider the issue, however, because it found other points dispositive.¹³³

One of the most noteworthy facets of the *Scherk* decision is the way in which the Justices voted and what the votes indicate about the inclinations of the current Court. Five Justices voted with the majority: Powell, Rehnquist, Stewart, Blackmun, and Burger. Each agreed there are important differences, with respect to the enforceability of arbitration clauses, between implied causes of action under the 1934 Act and express causes of action under the 1933 Act.¹³⁴ Three of the Justices holding that view—Powell, Rehnquist, and Blackmun—are still on the Court. Justice Stevens, then a judge on the Seventh Circuit,

128. *Id.* at 518-19 (citing *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972)).

129. *Id.* at 519-20 (emphasis added).

130. See *infra* note 275 and accompanying text.

131. *Scherk*, 417 U.S. at 512 n.6.

132. See *infra* text accompanying notes 234-53.

133. *Scherk*, 417 U.S. at 512 n.6. The parties also raised questions concerning the "sale of business" doctrine and the applicability of the United States securities laws to international agreements, but the Court declined to decide these issues for procedural reasons. *Id.* at 514 n.8, 516 n.9.

134. See *supra* text accompanying notes 119-30.

was the lone dissenter in the *Scherk* court of appeals decision, in which he argued against extending the *Wilko* doctrine to implied causes of action under the 1934 Act.¹³⁵ Shortly after the Supreme Court decided *Scherk*, Stevens replaced the author of the Supreme Court dissent in that case, Justice Douglas. Another of the dissenters in *Scherk*, Justice White, recently expressed his agreement with the view that the *Wilko* doctrine "cannot be mechanically transplanted to the 1934 Act."¹³⁶ Thus, five sitting Supreme Court Justices are on record as opposing the extension of the *Wilko* doctrine to implied causes of action under the 1934 Act. In addition, the two new members of the Court, Justices O'Connor and Scalia, are noted conservatives not inclined to extend judicial doctrines where Congress has not seen fit to provide an express basis for doing so.¹³⁷ The view of the present Supreme Court, therefore, certainly seems to be that *Wilko* should not be extended.

The Court's holding in *Scherk* was unquestionably a proper one, as at least one commentator has stated.¹³⁸ Lower courts have repeatedly attempted to limit the decision, however, and by doing so have grossly misconstrued both the majority opinion in that case and the inclinations of the present Supreme Court. Judicial attempts to limit *Scherk* generally have taken two forms. First, some courts state that *Scherk* carved out a narrow exception to the *Wilko* doctrine for international agreements.¹³⁹ As demonstrated, however, the majority opinion in *Scherk* stands for much more than that.¹⁴⁰ It would be more accurate to say that in *Scherk* the Court recognized that *Wilko*

135. See *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 616-18 (Stevens, J. dissenting), *rev'd*, 417 U.S. 506 (1974).

136. See *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 224 (1985) (White, J., concurring).

137. See, e.g., *Randall v. Loftsgaarden*, 106 S. Ct. 3143, 3150 (1986) (O'Connor, J.) (observing that "if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary to examine the additional considerations of policy") (quoting *Aaron v. SEC*, 446 U.S. 680, 695 (1980)); *Gott v. Walters*, 756 F.2d 902, 906 (D.C. Cir. 1985) (Scalia, J.) (In holding that the statute in question precluded judicial review of Veterans' Administration's use of certain methods and documents in determining servicemen's injuries from radiation exposure, Judge Scalia stated that the presumption favoring judicial review was overcome by specific statutory language, specific legislative history, contemporaneous judicial construction and congressional acquiescence, or "inferences of intent drawn from the statutory scheme as a whole.") (citations omitted).

138. See, e.g., *Scherk*, *supra* note 95, at 520-21.

139. See, e.g., *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979).

140. See *supra* text accompanying notes 119-30.

carved out a narrow exception to the general rule in section 2 of the FAA that mandates enforcement of arbitration clauses.¹⁴¹

Second, courts have attempted to limit the *Scherk* holding by either expressly or impliedly treating the majority's disapproval of an extension of the *Wilko* doctrine to implied causes of action under the 1934 Act as mere obiter dictum.¹⁴² Until the recent Supreme Court decision in *Dean Witter Reynolds Inc. v. Byrd*,¹⁴³ that judicial misconstruction of *Scherk* had led some commentators to conclude that it was a matter of settled law that predispute agreements to arbitrate implied claims under the 1934 Act were void,¹⁴⁴ and the lower courts generally agreed.¹⁴⁵ Some courts went so far as to make incorrect blanket statements to the effect that after *Wilko*, no federal securities claims can be subject to mandatory arbitration.¹⁴⁶ Indeed,

141. See *supra* text accompanying notes 21-38.

142. See *Mansbach*, 598 F.2d at 1030 (rejecting the argument that *Scherk* makes the *Wilko* doctrine inapplicable to 1934 Act claims); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 835 (7th Cir. 1977) (*Wilko* doctrine applies to 10b-5 cases, absent international considerations such as were dispositive in *Scherk*); see also *Dickinson v. Heinold Sec.*, 661 F.2d 638, 640 (7th Cir. 1981) (implied actions under 1934 Act are subject to *Wilko* doctrine); *De Lancie v. Birr, Wilson & Co.*, 648 F.2d 1255, 1259 (9th Cir. 1981) (same); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 826-29 (10th Cir. 1978) (*Wilko* doctrine applies to implied actions under both 1933 and 1934 Acts); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536-37 (3d Cir.), *cert. denied*, 429 U.S. 1010 (1976) (*Wilko* doctrine applies to implied actions under the 1934 Act); *Davend Corp. v. Michael*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,540, at 99,730 (S.D.N.Y. Apr. 14, 1976) (same); *Seymour v. Bache & Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,402, at 99,057 (S.D.N.Y. Jan. 14, 1976) (same).

143. 470 U.S. 213 (1985).

144. See, e.g., L. LOSS, *supra* note 69, at 1195 (stating that *Wilko* applied fully to implied actions); Krause, *supra* note 57, at 701 (contending that "in *Wilko v. Swan* the Supreme Court erected an absolute bar to predispute agreements that would compel arbitration of federal securities law claims"); Note, *supra* note 57, at 1168 (stating that "federal securities claims are not subject to arbitration"). Of course, in light of *Scherk* these statements are much too broad, see *supra* notes 118-37 and accompanying text, as was later made clear in the *Byrd* case, discussed *infra* notes 148-92 and accompanying text.

145. See, e.g., *Dickinson*, 661 F.2d at 640 (implied actions under 1934 Act are subject to *Wilko* doctrine); *De Lancie*, 648 F.2d at 1259 (same); *Moore*, 590 F.2d at 826-29 (*Wilko* doctrine applies to implied actions under both 1933 and 1934 Acts); *Ayres*, 538 F.2d at 536-37 (*Wilko* doctrine applies to implied actions under the 1934 Act); *Davend Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,730 (same); *Seymour*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,057 (same).

146. See, e.g., *Sawyer v. Raymond, James & Assocs.*, 642 F.2d 791, 792 (5th Cir. 1981); *Allegaert v. Perot*, 548 F.2d 432, 437 (2d Cir.), *cert. denied*, 432 U.S. 910 (1977); *Greater Continental Corp. v. Schechter*, 422 F.2d 1100, 1103 (2d Cir.

many defendants even conceded this point.¹⁴⁷

C. *BYRD* AND THE DEATH OF THE INTERTWINING DOCTRINE

The *Byrd* decision for the most part corrected these misconceptions.¹⁴⁸ *Byrd* was not, however, primarily about the enforceability of arbitration clauses as they apply to claims under the 1934 Act. Rather, *Byrd* sounded the death knell for the intertwining doctrine.

1. The Rise of Intertwining

The central problem presented in *Byrd* arose countless times in the lower courts after *Wilko* was decided.¹⁴⁹ The problem arose when a party combined clearly arbitrable state common-law or statutory claims¹⁵⁰ with nonarbitrable federal claims under the doctrine of pendent jurisdiction. Faced with this situation, the district courts had three possible choices: send the entire case to arbitration, send none of the case to arbitration, or send part of the case to arbitration.

The most obvious solution would be to sever the arbitrable

1970); *Cunningham v. Dean Witter Reynolds, Inc.*, 550 F. Supp. 578, 585 (E.D. Cal. 1982); *Berens v. Bache & Co.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,387, at 95,337 (S.D.N.Y. Jan. 31, 1974); *Shapiro v. Jaslow*, 320 F. Supp. 598, 599 (S.D.N.Y. 1970).

147. See, e.g., *Liskey v. Oppenheimer & Co.*, 717 F.2d 314, 315 (6th Cir. 1983); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 334 (5th Cir. 1981).

148. See *infra* notes 182-89 and accompanying text.

149. See, e.g., cases cited *infra* notes 151, 153 & 154.

150. There has never been any doubt that state claims, even in securities cases, are arbitrable. See *Liskey*, 717 F.2d at 320-21; *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 642-43 (7th Cir. 1981); *Kavit v. A.L. Stamm & Co.*, 491 F.2d 1176, 1181 (2d Cir. 1974); *DeHart v. Moore*, 424 F. Supp. 55, 56-57 (S.D. Fla. 1976); L. LOSS, *supra* note 69, at 1195. Until the Supreme Court asserted the preeminence of the FAA over state law, see *supra* notes 48-53 and accompanying text, some state courts had held agreements to arbitrate state securities claims nonarbitrable under state law. See *Sandefer v. Reynolds Sec., Inc.*, 618 P.2d 690, 691 (Colo. App. 1980) (state securities claims nonarbitrable) (overruled by *Sager v. District Court*, 698 P.2d 250, 255 (Colo. 1985) (antiwaiver provision of state securities law held contrary to the FAA and, therefore, void under the supremacy clause)); *Shearson, Hammill & Co. v. Vouis*, 247 So. 2d 733, 735 (Fla. Dist. Ct. App.) (state securities claims nonarbitrable), *cert. denied*, 253 So. 2d 444 (Fla. 1971); *Kiehne v. Purdy*, 309 N.W.2d 60, 62 (Minn. 1981) (holding agreements to arbitrate state securities claims void) (overruled by *Fairview Cemetery Ass'n v. Eckberg*, 385 N.W.2d 812, 819 (Minn. 1986) (holding state securities claims intertwined with common law claims are subject to arbitration)); *State ex rel. Geil v. Corcoran*, 623 S.W.2d 555, 557 (Mo. App. 1981) (holding state securities claims nonarbitrable). But see *Barbi v. W.E. Hutton & Co.*, 53 A.D.2d 562, 563, 384 N.Y.S.2d 828, 829 (1976) (held state law claims arbitrable).

claims from the nonarbitrable claims and stay the court proceedings on the arbitrable claims pending arbitration. Such a "sever and stay" approach found favor with many courts¹⁵¹ and commentators,¹⁵² largely because the approach heeded the *Wilko* doctrine while enforcing the parties' contract, as required by the FAA, to the greatest extent possible. Other courts, expressing a variety of concerns, adopted the "intertwining doctrine," holding that when arbitrable claims are intimately related factually to the nonarbitrable claims, the entire intertwined package should be adjudicated in federal court without arbitration.¹⁵³ Still others acknowledged the appropriateness of the sever and stay approach but, after ordering certain claims to arbitration, enjoined any arbitration proceedings pending resolution of the federal court action.¹⁵⁴

151. See *Liskey*, 717 F.2d at 320-21; *Dickinson*, 661 F.2d at 643-46; *Davend Corp. v. Michael*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,540, at 99,729 (S.D.N.Y. Apr. 14, 1976); *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21, 31 (E.D. Cal. 1974).

152. See, e.g., *Bell & Fitzgerald, Mixed Arbitrable/Nonarbitrable Disputes*, 16 REV. SEC. REG. 849, 853 (1983); Note, *supra* note 57, at 1184-86.

153. See *Belke v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.2d 1023, 1026-27 (11th Cir. 1982) (claims were inextricably intertwined); *Sawyer v. Raymond, James & Assocs.*, 642 F.2d 791, 792-93 (5th Cir. 1981) (bifurcation would lead to duplicate review of same facts); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 335-36 (5th Cir. 1981) (claims were for a single legal wrong); *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976) (claims were inextricably intertwined), *cert. denied*, 434 U.S. 824 (1977); *Wise v. Kidder Peabody & Co.*, 596 F. Supp. 1391, 1397-98 (D. Del. 1984) (all claims should be heard in one proceeding to effectuate purposes of FAA); *Frogner v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,504, at 96,927 (N.D. Cal. Sept. 26, 1983) (bifurcation would result in duplication of proof); *Cunningham v. Dean Witter Reynolds, Inc.*, 550 F. Supp. 578, 584-85 (E.D. Cal. 1982) (bifurcation would frustrate FAA purpose to make dispute resolution faster and simple); *Seymour v. Bache & Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,402, at 99,058 (S.D.N.Y. Jan. 14, 1976) (judicial economy requires litigation of entire matter in one forum); *Shapiro v. Jaslow*, 320 F. Supp. 598, 600 (S.D.N.Y. 1970) (due to collateral estoppel effect of arbitration, allowing arbitration of issues involved in nonarbitrable 1934 Act claims would frustrate exclusive jurisdiction provisions of 1934 Act). Some state courts have also applied the intertwining doctrine to nonarbitrable state securities claims. See *Sandefer*, 635 P.2d at 549-51 (facts too similar) (overruled by *Sager v. District Court*, 698 P.2d 250 (Colo. 1985) (holding state securities claims arbitrable)); *Laurence v. Corwin*, 75 A.D.2d 840, 841, 427 N.Y.S.2d 865, 866 (1980) (claims based on same facts).

154. E.g., *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 833-36 (7th Cir. 1977); *Sennett v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,378, at 97,502-03 (N.D. Ill. Apr. 9, 1980); *Peacock v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,586-87 (N.D. Ill. Sept. 17, 1979); *Stockwell v. Reynolds & Co.*, 252 F. Supp. 215, 220 (S.D.N.Y. 1965).

2. The Fall of Intertwining

The Supreme Court took the proper approach in the 1985 case of *Dean Witter Reynolds Inc. v. Byrd*¹⁵⁵ by rejecting the intertwining doctrine in favor of the sever and stay approach and by admonishing courts not to stay or enjoin arbitration pending the outcome of the federal court action.¹⁵⁶ Like *Scherk*, however, *Byrd* is much more important for what was not explicitly decided.

In *Byrd*, the plaintiff had sold his dental practice and invested \$160,000 of the proceeds with the defendant, Dean Witter, after signing an agreement containing an arbitration clause.¹⁵⁷ The plaintiff lost more than \$100,000 of that money in approximately seven months. He brought suit in federal court alleging violations of state law and Rule 10b-5.¹⁵⁸ Dean Witter moved to sever and stay the proceedings on the state claims pending arbitration,¹⁵⁹ but assumed that the claims under the 1934 Act were nonarbitrable and conceded that issue.¹⁶⁰ The district court denied the motion, holding that the claims should all be adjudicated together in federal court,¹⁶¹ and the Court of Appeals for the Ninth Circuit affirmed, adopting the intertwining doctrine.¹⁶² The circuits were split regarding the appropriateness of the intertwining doctrine,¹⁶³ and the Supreme Court agreed to decide the issue. In a well-reasoned opinion by Justice Marshall, the Court unanimously held that the intertwining doctrine was inconsistent with the FAA.¹⁶⁴

The Court's decision two years earlier in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*¹⁶⁵ foreshadowed the Court's holding on the issue of intertwining in *Byrd*. In *Moses H. Cone Memorial Hospital*, the Court stated strongly that the FAA "requires piecemeal resolution when necessary to give effect to an arbitration agreement."¹⁶⁶ The *Byrd* Court re-

155. 470 U.S. 213 (1985).

156. See *infra* notes 171-78 and accompanying text.

157. *Byrd*, 470 U.S. at 214-15.

158. *Id.* at 214.

159. *Id.* at 215.

160. *Id.*

161. See *id.* at 215-16 (referring to the district court's denial of motion to sever and stay proceedings).

162. *Byrd v. Dean Witter Reynolds, Inc.*, 726 F.2d 552 (9th Cir. 1983), *rev'd*, 470 U.S. 213 (1985).

163. See *supra* notes 151-54 and accompanying text.

164. See *Byrd*, 470 U.S. at 217.

165. 460 U.S. 1 (1983).

166. See *id.* at 20 (footnote omitted). That sentiment had been expressed

lied heavily on *Moses H. Cone Memorial Hospital* in its rejection of the intertwining doctrine.¹⁶⁷ The Court accepted the reasoning of those courts adopting the sever and stay approach,¹⁶⁸ stating that the FAA requires the arbitration of pendent claims even if that would result in inefficiencies due to the maintenance of proceedings in two forums.¹⁶⁹ By rejecting the intertwining doctrine, the Court signaled a further circumscription of the *Wilko* doctrine: that *Wilko* represents a limited exception to the strong national policy favoring the enforcement of arbitration clauses and cannot be used to swallow up the express mandate of section 2 of the FAA.¹⁷⁰

The death of the intertwining doctrine also seems to mark the end of the practice of enjoining the arbitration of severed state claims pending the outcome of the federal court suit.¹⁷¹ The *Byrd* Court undercut the only two justifications for adopting such an approach: judicial economy¹⁷² and collateral estoppel.¹⁷³ The *Byrd* Court explicitly rejected the notion that considerations of judicial economy can be a grounds for forestalling arbitration.¹⁷⁴ The Court also questioned the reasoning of some courts that had worried about the arbitration proceeding resulting in a collateral estoppel of issues to be resolved in the nonarbitrable claims being litigated in federal court.¹⁷⁵ Without deciding the issue, the Court pointed out that under *McDonald v. City of West Branch*¹⁷⁶ it was at best unclear whether a federal court would have to give full collateral estop-

by the Seventh Circuit in 1981. See *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 643 (7th Cir. 1981) ("A requirement to arbitrate may, in a particular instance, result in some duplication of effort, but this prospect cannot vitiate the agreement of the parties.").

167. See *Byrd*, 470 U.S. at 220-21.

168. See *supra* notes 151-56 and accompanying text.

169. *Byrd*, 470 U.S. at 220-21.

170. 9 U.S.C. § 2 (1982), discussed *supra* notes 21-65 and accompanying text.

171. See cases discussed *supra* note 154 and accompanying text.

172. See, e.g., *Sennett v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,378, at 92,502-03 (N.D. Ill. Apr. 9, 1980); *Peacock v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,586-87 (N.D. Ill. Sept. 17, 1979).

173. See, e.g., *Belke v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.2d 1023, 1026 (11th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 336 (5th Cir. 1981); *Cunningham v. Dean Witter Reynolds, Inc.* 550 F. Supp. 578, 582, 584-85 (E.D. Cal. 1982).

174. See *Byrd*, 470 U.S. at 220.

175. See *id.* at 221 & n.8 (citing cases *supra* note 173).

176. 466 U.S. 284, 292 (1984) (stating that in a section 1983 action, courts should not accord res judicata and collateral estoppel effect to an arbitration rendered pursuant to a collective bargaining agreement).

pel effect, in a federal securities case, to issues decided by an arbitration panel.¹⁷⁷ In concurrence, Justice White was even more resolute, stating simply that fears of collateral estoppel are no reason to refuse to compel arbitration forthwith.¹⁷⁸

Under *Byrd*, therefore, a court presented with arbitrable state claims and nonarbitrable federal claims must, on the motion of a party, sever and stay the arbitrable claims and direct that arbitration proceed without delay.¹⁷⁹ Those matters are clear from the decision. As noted above,¹⁸⁰ however, *Byrd* is perhaps more significant for what it did not decide. Justice Marshall, who dissented in *Scherk*, asserted that *Scherk* "questioned" the application of *Wilko* to claims under the 1934 Act but did not explicitly decide the issue. Justice Marshall stated that because Dean Witter had conceded the point in favor of nonarbitrability at the trial court by not moving to compel arbitration of the 1934 Act claims, the Court had to decline to decide that issue.¹⁸¹

In concurrence, Justice White was not nearly so reticent. Although he dissented in *Scherk*,¹⁸² he apparently had changed his mind about the enforceability of arbitration clauses to the extent they apply to implied actions under the 1934 Act. He noted that the premise of the intertwining doctrine before the Court was that the 1934 Act claims of *Byrd* were not arbitrable. He also stated, however: "Nonetheless, I note that this is a matter of substantial doubt."¹⁸³ Justice White went on to question the applicability of the *Wilko* reasoning to actions under the 1934 Act.¹⁸⁴

Justice White first read the majority opinion in *Wilko* as relying on three sections of the 1933 Act: section 14, which voids waivers; section 12(2), which creates a "special right" not available at common law in favor of plaintiffs; and section 22, which provides a plaintiff with a large selection of possible fo-

177. *Byrd*, 470 U.S. at 222-23.

178. *See id.* at 225 (White, J., concurring).

179. Some courts have stayed the nonarbitrable federal claims pending the outcome of the arbitration. *See, e.g.,* *Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,328, at 92,175 (W.D. Okla. Sept. 20, 1985); *Webb v. R. Rowland & Co.*, 613 F. Supp. 1123, 1124 (E.D. Mo. 1985). The advisability of this and other so-called "ordering" techniques are discussed *infra* notes 254-72 and accompanying text.

180. *See supra* text accompanying notes 155-56.

181. *Byrd*, 470 U.S. at 215 n.1.

182. *See Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 521, 531-32 (1974).

183. *Byrd*, 470 U.S. at 224 (White, J., concurring).

184. *See id.* at 224-25.

rum and provides for nationwide service of process. Justice White argued that, based on those sections, "*Wilko's* reasoning cannot be mechanically transplanted to the 1934 Act."¹⁸⁵ Although section 14 of the 1933 Act finds a corresponding section in 29(a) of the 1934 Act, the other two sections of the 1933 Act relied upon in *Wilko* have no counterpart in the 1934 Act. Unlike the options provided by section 22 of the 1933 Act, the 1934 Act provides for much narrower jurisdictional choices for a plaintiff; indeed, the federal courts are given exclusive jurisdiction over 1934 Act claims. More important, according to Justice White, is the complete absence in the 1934 Act of any equivalent to the 1933 Act's section 12(2), which expressly allows private causes of action. Under the 1934 Act section invoked by Byrd, section 10(b), the cause of action is a judicial creation. Justice White reasoned, therefore, that the phrase from the antiwaiver section of the 1934 Act, "waive compliance with any provision of this chapter," is literally inapplicable.¹⁸⁶ Moreover, *Wilko's* solicitude for the special right to bring a private cause of action, which was granted by Congress in the 1933 Act, "is not necessarily appropriate where the cause of action is judicially implied and not so different from the common-law action."¹⁸⁷ Justice White concluded by stating that he raised these points to emphasize that, notwithstanding all the lower court opinions applying *Wilko* to the 1934 Act, "the question remains open" and those lower court opinions "must be viewed with some doubt."¹⁸⁸

In fact, those lower court holdings must be viewed with more than "some doubt." After *Scherk* and *Byrd*, no longer is there any question where the Supreme Court stands on the issue of the enforceability of arbitration clauses that apply to claims under the 1934 Act,¹⁸⁹ particularly because five sitting Justices are on record opposing extension of the *Wilko* doctrine to claims brought under the 1934 Act.¹⁹⁰ Things have changed since *Wilko* was decided. As Justice, then Judge, Stevens

185. *Id.* at 224. Such a mechanical transplanting had been part of lower court reasoning. *Id.* at 215 n.1. See also *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268-69 (W.D. Tex. 1974) (arguing that the 1933 and 1934 Acts are identical insofar as the *Wilko* doctrine is concerned).

186. *Byrd*, 470 U.S. at 224-25 (White, J., concurring) (citation omitted).

187. *Id.* (footnote omitted).

188. *Id.*

189. As noted *infra* note 275 and accompanying text, there is still some question about this matter in the minds of a few lower court judges, notwithstanding the Supreme Court's strong statements.

190. See *supra* text accompanying notes 134-37.

noted, since 1953 there has been an "increasingly strong endorsement" by the federal courts, particularly the Supreme Court, of arbitration as an alternative to litigation.¹⁹¹ The Supreme Court has not yet expressly decided the question, but it has seemed to be positively itching for the right case to pare the *Wilko* doctrine down to its origins—express causes of action under the 1933 Act. It now has that opportunity, having granted certiorari in a case involving the arbitrability of a 10b-5 claim.¹⁹²

III. THE LEGACY OF THE *WILKO-SCHERK-BYRD* PROGRESSION

After the *Wilko-Scherk-Byrd* line of cases, some matters of doctrine are well-established while several important issues remain unresolved. Courts continue to debate what the three cases stand for with respect to a number of questions.

A. AGREEMENTS TO ARBITRATE EXISTING CONTROVERSIES

One issue more complex than it would seem at first glance involves the enforceability of agreements to arbitrate existing, as opposed to future and as yet unforeseen, controversies. Although courts generally agree about the broad principles, a great deal of confusion remains about the details.

Courts and commentators universally agree that the *Wilko* doctrine does not apply when a party agrees, after a dispute has arisen, to arbitrate that dispute.¹⁹³ A necessary corollary of that rule is that if a party voluntarily submits a securities claim to arbitration and is unsatisfied with the arbitrator's award, he

191. See *Alberto-Culver Co. v. Scherk*, 484 F.2d 611, 616 (7th Cir. 1973) (Stevens, J., dissenting), *rev'd*, 417 U.S. 506 (1974). See also *Tullis v. Kohlmeier & Co.*, 551 F.2d 632, 638 (5th Cir. 1977) (stating that since *Wilko* was decided there has been an increasingly strong judicial endorsement of arbitration). In other areas, the Supreme Court has recently come out very strongly in favor of enforcement of arbitration clauses. See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3353-54 (1985) (Sherman Act claims must be arbitrated if the international agreement between the parties so provides).

192. *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44).

193. *E.g.*, *Wilko v. Swan*, 346 U.S. 427, 438-39 (1953) (Jackson, J., concurring); *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972); *Moran v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242, 245-46 (3d Cir. 1968); *Kribs v. Bache, Halsey, Stuart, Shields, Inc.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,017, at 94,817 (S.D.N.Y. Dec. 7, 1982); Annotation, *supra* note 71, at 499.

cannot then seek redress of his grievances in court,¹⁹⁴ even if the claim is one as to which arbitration could not have been compelled under the *Wilko* doctrine.¹⁹⁵ Principles of res judicata are said to be fully applicable to securities arbitration proceedings, thus precluding a party from taking multiple bites at the apple.¹⁹⁶ In fact, in at least one case a court awarded sanctions against a party who sought to assert, in federal court, securities claims that had been submitted previously to an arbitrator.¹⁹⁷

The rule according res judicata effect to arbitral awards is a sensible, indeed necessary, one. Otherwise, a circular process would result. After arbitration, the losing party could sue in federal court. The winning party could then move to compel arbitration, citing the FAA,¹⁹⁸ and the court would have to grant the motion,¹⁹⁹ assuming the claims are not ones as to which arbitration clauses are void.²⁰⁰ The case would go back to arbitration, and the process would begin anew.²⁰¹ In addi-

194. *E.g.*, *Gardner v. Shearson, Hammill & Co.*, 433 F.2d 367, 368 (5th Cir. 1970), *cert. denied*, 401 U.S. 978 (1971); *Moran*, 389 F.2d at 246; L. LOSS, *supra* note 69, at 1195. *See also* *Behrens v. Skelly*, 173 F.2d 715, 720 (3d Cir.) (commenting on the binding effect of an arbitration award in a nonsecurities case), *cert. denied*, 338 U.S. 821 (1949); *Goldstein v. Doft*, 236 F. Supp. 730, 732-34 (S.D.N.Y. 1964) (arbitration award used to bar relitigation of claims in a nonsecurities case), *aff'd*, 353 F.2d 484 (2d Cir. 1965).

195. *See Moran*, 389 F.2d at 246.

196. *See Pallante v. Paine, Webber, Jackson and Curtis, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,219, at 91,615 (S.D.N.Y. May 14, 1985); *Maidman v. O'Brien*, 473 F. Supp. 25, 30-34 (S.D.N.Y. 1979). *See also* *Davis v. Chevy Chase Fin. Ltd.*, 667 F.2d 160, 172 (D.C. Cir. 1981) (commenting on the res judicata effect of an arbitration award in a nonsecurities case); *Albin Stevedore Co. v. Central Rigging & Contracting Corp.*, 308 F.2d 347 (9th Cir. 1962) (nonsecurities claims disposed of by arbitration award); *James L. Saphier Agency v. Green*, 190 F. Supp. 713 (S.D.N.Y.) (valid arbitration award has same res judicata effect as the judgment of a court), *aff'd*, 293 F.2d 769 (2d Cir. 1961); *Livingston v. Shreveport-Texas League Baseball Corp.*, 128 F. Supp. 191, 202 (W.D. La. 1955) (same); RESTATEMENT (SECOND) OF JUDGMENTS § 84 (1982) (stating that res judicata principles apply to arbitration proceedings); 18 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE & PROCEDURE § 4475 (1981) (same).

197. *Pallante*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,614-15.

198. 9 U.S.C. §§ 1-14 (1982).

199. *See id.* § 3.

200. *See infra* notes 273-313 and accompanying text.

201. Although principles of res judicata and collateral estoppel are sometimes confused, in this case the distinction is an important one. Res judicata prevents the relitigation of claims; collateral estoppel prevents the relitigation of issues. Although arbitral awards must be given res judicata effect to prevent the circular process described here, such is not the case with collateral estop-

tion, a contrary rule would eviscerate the provisions of the FAA making arbitration clauses enforceable;²⁰² arbitration would be a mere practice session and a waste of time and resources.

The rule enforcing agreements to arbitrate existing disputes also is a sound one, as even those who oppose enforcing predispute arbitration clauses recognize.²⁰³ Agreements to arbitrate existing disputes are closely akin to settlement agreements,²⁰⁴ which must be enforced.²⁰⁵ As noted, however, the distinction between predispute and postdispute arbitration agreements is a difficult one to maintain under the reasoning of *Wilko* and its progeny.

In *Wilko*, the Supreme Court took the paternalistic view that section 14 of the 1933 Act²⁰⁶ prohibits a party from waiving her right to sue in federal court in favor of arbitration.²⁰⁷ If section 14 really stands for that proposition, no logical reason justifies limiting *Wilko* to predispute agreements to arbitrate. Waiver is waiver, and section 14, according to the *Wilko* Court's reasoning, cannot logically be limited to only predispute agreements, notwithstanding Justice Jackson's concurrence²⁰⁸ and other courts' statements to the contrary.²⁰⁹ This is not to say that the *Wilko* doctrine should be extended to void agreements

pel. The collateral estoppel effect to be given arbitration awards is discussed *infra* notes 254-72 and accompanying text.

202. 9 U.S.C. § 2 (1982).

203. See, e.g., Note, *Enforceability of Arbitration Agreements In Fraud Actions Under the Securities Act*, 62 YALE L.J. 985, 994-97 (1953) (arguing in favor of enforcing agreements to arbitrate existing disputes but against enforcing predispute agreements); Comment, *Arbitration of Investor-Broker Disputes*, 65 CALIF. L. REV. 120, 137-38 (1977) (same). Even the SEC draws a distinction between the two. See Notice to Broker-Dealers Concerning Arbitration of Future Disputes, Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,976 (July 2, 1972) (stating that SEC generally supports arbitration as an economical and efficient means of resolving existing disputes but questioning propriety of brokers' use of predispute arbitration agreements); 3 L. LOSS, SECURITIES REGULATION 1814 (2d ed. 1961) (stating that the SEC had distinguished agreements to arbitrate existing disputes from agreements to arbitrate disputes arising in the future in its *amicus curiae* brief in *Wilko*).

204. See Note, *supra* note 203, at 994-95; Annotation, *supra* note 71, at 499.

205. See, e.g., *Friedman v. Bache & Co.*, 439 F.2d 349, 349-50 (5th Cir. 1971); *Korn v. Franchard Corp.*, 388 F. Supp. 1326, 1328-29 (S.D.N.Y. 1975).

206. 15 U.S.C. § 77n (1982).

207. See *supra* notes 77-88 and accompanying text.

208. See *Wilko v. Swan*, 346 U.S. 427, 438-39 (1953) (Jackson, J., concurring) (concurring with the Court's holding insofar as it bars only the enforcement of agreements to arbitrate existing claims).

209. See cases cited *supra* note 193.

to arbitrate existing disputes or agreements to settle, but to show the errors in the Court's reasoning in *Wilko* that section 14 of the 1933 Act prohibits a party from waiving her right to sue in federal court.²¹⁰ The *Wilko* reasoning simply proves too much.

Although courts and commentators agree on the statements of doctrine concerning the res judicata effect of arbitral decisions and the enforceability of agreements to arbitrate existing disputes, certain details of application prove troublesome. One problem, which only arises because of the fallacious distinction made between predispute agreements and postdispute agreements, is defining when a controversy becomes "existent" so that agreements to arbitrate it will be enforced. Suppose a customer has reason to believe his broker has violated section 12(2) of the 1933 Act with respect to the customer's account and thereafter the customer executes an agreement to arbitrate all disputes. If only existing disputes under section 12(2) can be forcibly arbitrated, the question is whether the broker may compel arbitration if the customer sues under that section for violations the customer had reason to know about when he signed the agreement. The better authority seems to say that the section 12(2) claim was an existing dispute at the time the customer signed the arbitration clause if the customer had reason to know about the violation.²¹¹

Courts recognize that although a party cannot give a valid release of securities claims in advance,²¹² a party can irrevocably settle or agree to arbitrate claims that have ripened or matured at the time the agreement was executed.²¹³ A ripened or

210. Other problems in the Court's reasoning in *Wilko* are discussed *supra* notes 95-103 and accompanying text.

211. See, e.g., *Korn v. Franchard Corp.*, 388 F. Supp. 1326, 1328-29 (S.D.N.Y. 1975); *Mittendorf v. J.R. Williston & Beane, Inc.*, 372 F. Supp. 821, 834-35 (S.D.N.Y. 1974).

212. See, e.g., *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268-69 (1st Cir. 1966); *Schine v. Schine*, 254 F. Supp. 986, 988 (S.D.N.Y.), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1966); *Foreman v. Holsman*, 10 Ill. 2d 551, 554-55, 141 N.E.2d 31, 32-33 (1957).

213. See, e.g., *Friedman v. Bache & Co.*, 439 F.2d 349, 350 (5th Cir. 1971); *Korn*, 388 F. Supp. at 1328-29; *Mittendorf*, 372 F. Supp. at 834-35; *Cohen v. Tenney Corp.*, 318 F. Supp. 280, 284 (S.D.N.Y. 1970). The justification for the rule is that a party should be deemed only to have made a waiver when the party knowingly and voluntarily relinquished the right to sue in court. See, e.g., *Seymour v. Bache & Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,402, at 99,058 (S.D.N.Y. Jan. 14, 1976); *Cohen*, 318 F. Supp. at 282. If that is the only justification for permitting enforcement of agreements to arbitrate existing disputes, it is difficult to see why that would not also apply to agree-

matured claim is said by the majority of courts to be one the claimant knew of or, upon reasonable inquiry, should have known of at the time of entering into the agreement.²¹⁴ This majority rule is not universally accepted. At least one court has indicated that for the agreement to arbitrate to cover the dispute as a ripened dispute, the controversy must already exist and the claimant must already have full knowledge of the facts at the time the agreement is entered into.²¹⁵ That rule, however, would conflict directly with the widely accepted maxim that, under the FAA, all doubts concerning the application of an arbitration clause are, as a matter of federal law, to be construed liberally in favor of arbitration.²¹⁶ Moreover, such a rule would merely benefit the lazy claimant and punish those who exercise reasonable diligence over their financial affairs. For good reason, the approach is not widely accepted.

The very existence of the rule allowing enforcement of arbitration clauses with respect to existing disputes thus illustrates the judicial ambivalence about the *Wilko* doctrine and represents one way courts, over time, have whittled at the *Wilko* decision.

B. THE ARBITRABILITY OF BROKER-BROKER DISPUTES

Another subject that illustrates such a whittling away of the *Wilko* doctrine is the arbitrability of disputes between exchange members and their employees. This subject also is given to simple statements of doctrine but contains turbulent undercurrents.

Each of the major stock exchanges requires that new members²¹⁷ agree to abide by the constitution and rules of the exchange. The constitutions of the major exchanges require

ments to arbitrate future disputes. Such agreements can be entered into just as knowingly.

214. See *Mittendorf*, 372 F. Supp. at 834-35.

215. See *Seymour*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 99,058.

216. See *supra* notes 35-38 and accompanying text.

217. Most, if not all, major brokerage firms are members of the national or regional stock exchanges. Firms' officers are treated as though they were exchange members under the exchanges' definitions of "allied members." See, e.g., New York Stock Exchange Constitution, art. I, § 3(c), reprinted in NEW YORK STOCK EXCHANGE, INC., CONSTITUTION AND RULES (CCH) ¶ 1003(c), at 1051 (1986) [hereinafter N.Y.S.E. CONST. & RULES]. For purposes of this Article, allied members are treated as though they were members.

members to arbitrate all disputes with other members.²¹⁸ Most individual brokers are employees of brokerage houses that are themselves members of the exchange. If brokers, in their individual capacity, sue an exchange member such as their employer, that dispute must also be arbitrated²¹⁹ according to exchange rules.²²⁰ Courts interpret the exchanges' rules and constitutions as contracts between the members.²²¹ The exchanges' rules requiring members to arbitrate their disputes therefore create predispute arbitration agreements between all members of the exchange. Despite the *Wilko* doctrine, courts uniformly recognize that when an exchange member has a dispute with another exchange member, that dispute must be arbitrated on the motion of either party.²²²

The obvious question, at least with respect to express causes of action under the 1933 Act, is why the *Wilko* doctrine does not prohibit enforcement of these predispute arbitration agreements between exchange members. According to the *Wilko* Court's reading of section 14 of the 1933 Act, a party cannot waive in advance her right to sue in federal court.²²³

Courts justify the exemption for exchange members in two ways. First, courts note that section 28(b) of the 1934 Act²²⁴

218. See, e.g., New York Stock Exchange Constitution, art. XI, § 1, reprinted in N.Y.S.E. CONST. & RULES, *supra* note 217, ¶ 1501, at 1075.

219. See, e.g., *Katz v. Shearson Hayden Stone, Inc.*, 438 F. Supp. 637, 640-42 (S.D.N.Y. 1977). But see *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536-37 (3d Cir. 1976) (holding exchange rule requiring employees to arbitrate disputes with exchange members inapplicable under facts of case and further holding rule would be void if applicable), *cert. denied*, 429 U.S. 1010 (1977).

220. See, e.g., New York Stock Exchange Rule No. 347, reprinted in N.Y.S.E. CONST. & RULES, *supra* note 217, ¶ 2347, at 3599.

221. See, e.g., *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1211 (2d Cir. 1972), *cert. denied*, 406 U.S. 949 (1973); *Legg, Mason & Co. v. Mackall & Coe, Inc.*, 351 F. Supp. 1367, 1370 (D.D.C. 1972); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 769 (S.D.N.Y. 1968).

222. See *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 634-35 (5th Cir. 1977); *Muh v. Newburger, Loeb & Co.*, 540 F.2d 970, 973 (9th Cir. 1976); *Coenen*, 453 F.2d at 1211; *In re Revenue Properties Litig. Cases*, 451 F.2d 310, 313 (1st Cir. 1971); *Himebaugh v. Smith*, 476 F. Supp. 502, 509-10 (C.D. Cal. 1978); *Legg, Mason & Co.*, 351 F. Supp. at 1371-72; *Brown*, 287 F. Supp. at 772-75; see also Annotation, *supra* note 71, at 507-08 (stating that stock exchange arbitration agreements are not voided by § 14 of the 1933 Act or by § 29(a) of the 1934 Act).

223. See *supra* notes 79-88 and accompanying text.

224. Section 28(b) provides in relevant part: "Nothing in this chapter shall be construed to modify existing law with regard to the binding effect (1) on any member of or participant in any self-regulatory organization of any action taken by the authorities of such organization to settle disputes between its

permits the exchanges to mandate arbitration for disputes that arise under the 1934 Act.²²⁵ By its terms, however, section 28(b) does not apply at all to the 1933 Act,²²⁶ under which *Wilko* was decided.²²⁷ That has not troubled most courts; they simply find the 1933 and 1934 Acts *in pari materia* and invent the fiction that section 28(b) applies to both Acts.²²⁸ The logic of these cases is so twisted it borders on the bizarre. Initially, courts mistakenly apply the wrongly-decided *Wilko* case to implied claims under the 1934 Act. Next, in analyzing those claims under the 1934 Act, the same courts wrongly apply section 28(b) of the 1934 Act as though it were contained in the 1933 Act. The result is that claims that should be arbitrated are sent to arbitration, but only through the triple misconstruction of the relevant statutes.

The second justification for the rule allowing exchange members to agree to arbitrate disputes among themselves is considerably more sound and is a variation of the "sophisticated investor" exception to the *Wilko* doctrine.²²⁹ Congress enacted the securities acts in the 1930s in part to restore investor confidence in the markets.²³⁰ As one court stated, "It was assumed that dealers could fend for themselves; it was the investing public that was in need of protection."²³¹ The 1933 Act makes no distinction between dealers and other purchasers of securities, however, so the *Wilko* Court's reading of that statute makes this justification difficult to reconcile with that case. The justification is nevertheless sound for implied causes of action under both the 1933 and 1934 Acts. When the judiciary creates an implied cause of action, it should be free to circumscribe that cause of action as it sees fit. Circumscribing an implied cause of

members or participants" Securities Exchange Act of 1934, § 28(b), 15 U.S.C. § 78bb(b) (1982).

225. See, e.g., *Tullis*, 551 F.2d at 635-38; *Brown*, 287 F. Supp. at 772-75.

226. "Nothing in this chapter" 15 U.S.C. § 78bb(b) (1982) (emphasis added).

227. See *supra* notes 77-88 and accompanying text.

228. See, e.g., *Tullis*, 551 F.2d at 635-36 (favorably citing previous court decisions distinguishing *Wilko* and finding that § 28(b) of the 1934 Act also applies to the 1933 Act); *Brown*, 287 F. Supp. at 775 (stating that the 1933 and 1934 Acts were part of the same legislative program and applying § 28(b) to the 1933 Act is in accord with legislative intent).

229. See *infra* text accompanying notes 234-53.

230. See *Sterk*, *supra* note 95, at 519.

231. *Brown*, 287 F. Supp. at 772 (footnote omitted); see also *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213-14 (2d Cir.) (citing language by various courts emphasizing the 1934 Act's focus on protecting investors), *cert. denied*, 406 U.S. 949 (1972).

action to conform to the policies behind the statutes under which the implied action is created is clearly appropriate.

Although the doctrine in the area of exchange member disputes is simple enough, complications arise for the same reason they arise in the area of agreements to arbitrate existing disputes. For instance, sometimes a situation will develop in which a person has a dispute with an exchange member and thereafter becomes an exchange member himself.²³² Courts handle such cases the same as other arbitration agreements entered into after the dispute arose: only if the claimant knew or had reason to know of the dispute at the time he became an exchange member must he arbitrate.²³³

The subject of enforcing arbitration agreements between exchange members is important primarily because it represents yet another way in which the courts have pared back the *Wilko* doctrine. Although the 1933 Act sections found crucial in *Wilko* make no distinction between brokers and investors, courts have found in that distinction a way of limiting *Wilko* even further.

C. THE SOPHISTICATED INVESTOR EXCEPTION— ITS TIME HAS COME

The sophisticated investor exception to the *Wilko* doctrine, like the rule permitting exchange members to arbitrate disputes, is based on the policy behind the securities acts. It is an idea whose time has come.

The primary purpose of the securities laws is to protect investors who are not able to protect themselves.²³⁴ It therefore seems reasonable to ask, as many courts have,²³⁵ that limitations on the strong national policy favoring the enforcement of arbitration clauses²³⁶ be confined to cases in which the policy of the securities acts requires that the FAA be so limited. The

232. See, e.g., *De Lancie v. Birr, Wilson & Co.*, 648 F.2d 1255 (5th Cir. 1981); *Coenen*, 453 F.2d at 1210.

233. See, e.g., *De Lancie*, 648 F.2d at 1258; cf. L. LOSS, *supra* note 69, at 1195 (stating that "depending on the circumstances" a party who becomes an exchange member after the dispute arose may or may not be obligated to arbitrate). But see *Coenen*, 453 F.2d at 1212 (stating that member is bound to arbitrate any controversy).

234. See, e.g., *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 834 (7th Cir. 1977) (securities acts passed to protect small investors); *Brown*, 287 F. Supp. at 772; Neville, *The Enforcement of Arbitration Clauses in Investor-Broker Agreements*, ARB. J., Mar. 1979, at 9.

235. See *infra* notes 243-44 and accompanying text.

236. See *supra* text accompanying note 35.

Supreme Court recently noted that the strong national policy embodied in the FAA requires that agreements to arbitrate be strictly enforced by the courts absent a countervailing policy contained in another statute.²³⁷ Protection of investors, as expressed by the 1933 and 1934 Acts, constitutes such a countervailing statutory policy.²³⁸ When investors do not need the government's hand to decide which bargains are good and which are bad, that countervailing policy no longer exists, however, and the FAA requires that courts enforce the contractual agreement to arbitrate disputes.

As Justice Douglas correctly pointed out in *Scherk*, the securities acts do not expressly distinguish between small and large, sophisticated and unsophisticated, corporate and individual investors.²³⁹ For that reason, it would be a mistake to refuse to accord any investor the rights expressly given her by Congress. Nevertheless, Congress did not expressly mandate that arbitration clauses be voided; even for express causes of action under the 1933 Act, that result was reached by the courts in a twisted reading of the statute.²⁴⁰ Moreover, Congress certainly did not create the private causes of action under the 1934 Act that are so often the subject of cases involving arbitration clauses.²⁴¹ Nor did Congress mandate that the *Wilko* result be extended to those implied causes of action.²⁴² When investor protection is judicially created, the judiciary can and must limit that protection to those whose need prompted the enactment of the securities laws: individual investors not sophisticated enough to protect themselves adequately. The strong policy embodied in the FAA requires no less. Courts have begun to agree and are now more inclined to read both *Wilko* and *Scherk* in light of the identity of the party seeking to avoid arbitration.

Two courts have expressly adopted the sophisticated investor exception to *Wilko*, holding that when both parties to an agreement with an arbitration clause are sophisticated in busi-

237. See *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985).

238. See, e.g., *Weissbuch*, 558 F.2d at 834-36.

239. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 526 (1974) (Douglas, J., dissenting) ("The Act does not speak in terms of 'sophisticated' as opposed to 'unsophisticated' people dealing in securities. The rules when the giants play are the same as when the pygmies enter the market."). The majority in *Scherk* refused to rule on a sophisticated investor exception to *Wilko* because it based its decision on other grounds. See *id.* at 512 n.6.

240. See *supra* notes 95-101 and accompanying text.

241. See *infra* notes 275-77 and accompanying text.

242. See *infra* notes 290-92 and accompanying text.

ness affairs, neither party may claim the benefit of the *Wilko* doctrine.²⁴³ Other courts seem ready to reach the same decision given the proper case.²⁴⁴ Indeed, as some courts have pointed out, the sophistication of the party seeking to avoid arbitration was an aspect at work in both *Wilko* and *Scherk*.²⁴⁵ In *Wilko*, the party seeking to avoid arbitration was an individual investor; in *Scherk*, it was a corporation. Nonetheless, the Supreme Court has not yet placed its imprimatur on the sophisticated investor exception, although it has been asked to do so.²⁴⁶

If courts adopt a sophisticated investor exception to the *Wilko* doctrine, it should encompass at least three elements. First, the key consideration for the exception should be whether the investor is of a type needing protection from parties who might trick, cajole or force her to give up the right to sue in federal court. In many cases the party seeking to avoid arbitration appears to have considerable resources, at least judging from the size of the investments involved.²⁴⁷ Courts should not base the exception exclusively on the financial re-

243. See *Alco Standard Corp. v. Benalal*, 345 F. Supp. 14, 24 (E.D. Pa. 1972); *GCA Corp. v. Coler*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,339, at 91,815 (S.D.N.Y. Jan. 13, 1972).

244. See *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 835 (7th Cir. 1977) (holding *Wilko* doctrine applicable because, like *Wilko* and unlike *Scherk*, plaintiff was an individual investor); *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 634 n.4 (5th Cir. 1977) (refusing to apply *Wilko*, in part because plaintiffs were experienced businessmen); *McMahon v. Shearson/American Express, Inc.*, 618 F. Supp. 384, 386 (S.D.N.Y. 1985) ("Arbitration clauses are routinely upheld by the courts, and, given plaintiffs' sizeable investment, there is nothing to indicate that they were without bargaining power."), *rev'd on other grounds*, 788 F.2d 94, 96-98 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44). Cf. *Friedman v. World Transp., Inc.*, 636 F. Supp. 685, 689-92 (N.D. Ill. 1986) (holding that forum selection clause was enforceable against sophisticated investor). But see *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974) (refusing to adopt sophisticated investor exception).

245. See, e.g., *Weissbuch*, 558 F.2d at 835 (citing *Wilko v. Swan*, 346 U.S. 427, 435 (1953); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 515-18 (1974)).

246. In *Scherk* the defendant asked the Court to limit *Wilko* to cases in which the parties have disparate bargaining power. See *Scherk*, 417 U.S. at 512 n.6. The Court declined to do so, basing its decision on other grounds. See *id.*

247. In one remarkable case, the plaintiffs, a husband and wife, alleged that they had invested approximately \$13.5 million with the defendant broker, of which approximately \$9.5 million was lost. See *Brener v. Becker Paribas Inc.*, 628 F. Supp. 442, 445 (S.D.N.Y. 1985); see also *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 214 (1985) (plaintiff dentist sold his business and invested \$160,000 with defendant); *Shotto v. Laub*, 632 F. Supp. 516, 519 (D. Md. 1986) (two of the plaintiffs, the Shottos, invested more than \$125,000 with defendant); *Berens v. Bache & Co.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep.

sources of the parties, however, as some courts seem inclined to do.²⁴⁸ An investor may be of the type needing protection regardless of her resources. Indeed, the financially unsophisticated person who builds up a retirement nest egg or who inherits a large sum may be precisely the type of potential victim for whom protection is most needed.²⁴⁹ Resources should be considered by a court if the manner in which the plaintiff acquired or used the resources indicates a sophistication in financial matters.²⁵⁰

In addition, the party invoking the sophisticated investor exception should carry the burden of demonstrating its applicability. If the financial sophistication of a party is to be an exception to a general rule, it is consistent with standard burdens of persuasion that the party invoking the exception bear the burden.

Finally, institutional investors should automatically fall within the exception. Although it may be true that some institutions are unsophisticated, if an individual making investments as a representative of an institution is not sophisticated enough to hold his own in the rough and tumble world of finance, that person should be discouraged from dabbling in the financial markets, not coddled by the courts.

Two commentators have suggested possible parameters for the sophisticated investor exception that merit attention. One commentator would allow a matter that otherwise would fall within the *Wilko* doctrine to proceed to arbitration if a party

(CCH) ¶ 94,387, at 95,337 (S.D.N.Y. Jan. 31, 1974) (plaintiff had invested \$55,000).

248. See, e.g., *McMahon v. Shearson/American Express, Inc.*, 618 F. Supp. 384, 386 (S.D.N.Y. 1985) (holding based in part on plaintiffs' sizeable investment), *rev'd on other grounds*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44).

249. Actually, the FAA fully provides for protection of the unsophisticated through its prohibition on the enforcement of arbitration clauses in circumstances whereby any contract would be held unenforceable. See 9 U.S.C. § 2 (1982). This would argue strongly in favor of overruling *Wilko* in its entirety and enforcing all arbitration agreements unless one party can void the agreement on a contractual basis as contemplated by § 2 of the FAA. Indeed, this Article advocates that *Wilko* be overruled, either by congressional action or by Supreme Court decision on just such a basis. See *infra* text accompanying notes 426-28. Given the degree to which *Wilko* is imbedded in the jurisprudence of this area of law, however, the case probably will not be overruled by the Supreme Court. Thus, the judicially-created sophisticated investor exception is the next best alternative.

250. See, e.g., *McMahon*, 618 F. Supp. at 386 ("Arbitration clauses are routinely upheld by the courts, and, given plaintiffs' sizeable investment, there is nothing to indicate that they were without bargaining power.").

could show that at the time the agreement was entered into the parties had equal bargaining power.²⁵¹ To base the exception solely on equality of bargaining power, however, would be ill-advised. Two parties both can be extremely sophisticated and yet not have equal bargaining power. Furthermore, such a rule would not automatically include institutional investors.

A better rule was suggested by Professor Louis Loss as reporter for the Federal Securities Code.²⁵² Under the Federal Securities Code rule, the *Wilko* doctrine would not apply "between any persons if a court determines, on consideration of their financial and legal sophistication and the relationship between them, that the purposes of this Code do not require the [voiding of their agreement to arbitrate]."²⁵³ The only improvement to be made on Professor Loss's rule would be the inclusion of the express understanding that institutions as such are sophisticated enough to warrant application of the exception. Adoption of such a rule would protect all the interests requiring protection. It would reconcile the conflicting policies embodied in the FAA and the securities acts by enforcing arbitration clauses to the fullest extent possible commensurate with the protection of those who Congress felt were most in need of protection—small, individual investors. Furthermore, the rule would protect the parties' reasonable expectations as expressed in their agreement.

D. COLLATERAL ESTOPPEL AND THE PROBLEM OF ORDERING

Whereas the sophisticated investor exception presents a relatively clear choice to a court because the court can either accept the exception or reject it, a more vexing problem confronting courts that have to decide which issues to send to arbitration and which to adjudicate is the problem of ordering. The problem arises when a plaintiff includes in her complaint both claims as to which arbitration can be compelled and claims as to which the *Wilko* doctrine applies.²⁵⁴ The court can permit the arbitration and court case to proceed simultaneously, or rule that one should conclude before the other goes forward. If

251. See Neville, *supra* note 234, at 9.

252. See *supra* note 96.

253. 2 FEDERAL SECURITIES CODE § 1725(b)(3)(C) (1980).

254. How these claims divide up—that is, which claims fall under the *Wilko* doctrine and which do not—is discussed *infra* notes 273-313 and accompanying text.

the court chooses the latter option, it must also decide which proceeding should go first. This is the problem of ordering.

Several considerations are at stake in the ordering issue. The most important is the degree to which collateral estoppel²⁵⁵ will affect the proceeding that goes last. If, for example, an arbitration proceeding results in a resolution of issues that then precludes retrying those issues in federal court, the meaningfulness of the right to sue in federal court is greatly diminished. Concomitantly, if resolution of issues in federal court precludes raising those issues again in arbitration, the arbitration becomes meaningless. Thus, if arbitration resolution is given full collateral estoppel effect in federal court, or if court resolution is given full collateral estoppel effect in arbitration, the proceeding that takes place last in time is short-changed.

Until recently, courts and commentators generally agreed that issues decided in an arbitration proceeding are to be given full collateral estoppel effect in court.²⁵⁶ The Supreme Court has since cast a shadow of doubt over the matter. In *McDonald v. City of West Branch*,²⁵⁷ the Supreme Court held that a court should not, in a civil rights action under 42 U.S.C. § 1983, give full collateral estoppel effect to an arbitration proceeding that takes place pursuant to a collective bargaining agreement.

The Supreme Court referred to *McDonald* in the *Byrd* opinion in response to the plaintiff's argument that arbitration of issues common to both arbitrable and nonarbitrable claims would be inappropriate because collateral estoppel would effectively make the arbitration proceeding one in which even non-arbitrable claims were decided.²⁵⁸ In rejecting that argument, the Court stated that it is unclear what preclusive effect an arbitration proceeding would have on subsequent federal court

255. Collateral estoppel, the doctrine of issue preclusion, should not be confused with *res judicata*, the doctrine of claim preclusion. See *supra* notes 196-202 and accompanying text. Three requirements must be met for collateral estoppel to bar relitigation of an issue: the issue must be identical to the one already litigated; the issue must actually have been litigated by the parties in the earlier proceeding; and the determination of the issue in the prior proceeding must have been essential to the decision in that proceeding. See *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1360 (11th Cir. 1985).

256. See, e.g., *Maidman v. O'Brien*, 473 F. Supp. 25, 30-34 (S.D.N.Y. 1979); *James L. Saphier Agency v. Green*, 190 F. Supp. 713, 718-21 (S.D.N.Y.), *aff'd*, 293 F.2d 769, 774 (2d Cir. 1961); 18 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 196, § 4475.

257. 466 U.S. 284, 292 (1984).

258. *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221-24 (1985).

action.²⁵⁹ Although the Court left open the possibility that collateral estoppel *would* make the arbitration proceeding one in which nonarbitrable claims were effectively adjudicated,²⁶⁰ it ordered the arbitration to take place nonetheless.²⁶¹ Apparently the Court agreed with those courts that had taken the position that the threat of collateral estoppel "does not justify denying arbitration of otherwise arbitrable intertwined state law claims."²⁶² Justice White, in concurrence, made his view plain by stating that fears of collateral estoppel almost never justify refusing to order arbitrable claims to arbitration.²⁶³

Cases decided after *Byrd* have taken the hint and rethought the maxim that collateral estoppel is fully applicable to issues decided before an arbitrator. In a thoughtful decision, the United States Court of Appeals for the Eleventh Circuit recently ruled in *Greenblatt v. Drexel Burnham Lambert, Inc.*²⁶⁴ that application of collateral estoppel is within the sound discretion of the judge.²⁶⁵ The Eleventh Circuit in *Greenblatt* cautioned that federal courts should be hesitant to give collateral estoppel effect to an arbitration if it would result in the nonlitigation of claims that cannot be arbitrated.²⁶⁶ The *Greenblatt* court nonetheless gave the arbitration proceeding full collateral estoppel effect in the case before it.²⁶⁷

259. See *id.* at 222-23.

260. The Court declined to decide the matter. See *id.* at 223.

261. See *id.* at 223-24.

262. *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 644 (7th Cir. 1981).

263. See *Byrd*, 470 U.S. at 225 (White, J., concurring).

264. 763 F.2d 1352 (11th Cir. 1985).

265. *Id.* at 1360.

266. See *id.* at 1361. *Greenblatt* involved multiple claims against a broker by a customer, some of which were fully arbitrable, but also including a claim under the Racketeering Influenced and Corrupt Organizations Act (RICO), which some courts, including the Eleventh and Second Circuits, have held to be nonarbitrable. See, e.g., *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 98-99 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44); *Greenblatt*, 763 F.2d at 1361-62. There is, however, a great deal of authority to the contrary. See, e.g., *Sacks v. Dean Witter Reynolds Inc.*, 627 F. Supp. 377, 379-81 (C.D. Cal. 1985); *Ross v. Mathis*, 624 F. Supp. 110, 116-17 (N.D. Ga. 1985); *West v. Drexel Burnham Lambert, Inc.*, 623 F. Supp. 26, 28-29 (W.D. Wash. 1985); *Finn v. Davis*, 610 F. Supp. 1079, 1083 (S.D. Fla. 1985); *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,276, at 91,899 (W.D. Pa. Apr. 19, 1985), *rev'd in part*, 797 F.2d 1197, 1198 (3d Cir. 1986) (denying arbitration for RICO claim based on § 10(b) of the 1934 Act, but compelling arbitration for RICO claims involving mail and wire fraud).

267. The court decided that full collateral estoppel effect should be given to the earlier arbitration proceeding as it had resolved the issues that would be crucial in the nonarbitrable RICO action. See *Greenblatt*, 763 F.2d at 1361. It

The *Greenblatt* decision represents a sensible approach to the problem. Collateral estoppel is a common-law doctrine and as such must undergo judicial modification and qualification over time to meet changing circumstances. It should not be construed to be so inflexible as to flout the will of Congress, if the courts discern such a will,²⁶⁸ that certain claims must receive a judicial hearing. It is also reasonable, however, to leave open the possibility that collateral estoppel effect will be given to arbitration decisions when, as in *Greenblatt*, the court determines that the issues received a fair and complete hearing in the arbitration proceeding and that litigation in federal court would simply be a waste of time and resources for all concerned.

Another consideration at stake in resolving the ordering problem is judicial economy, a justification often cited by courts that choose to stay arbitration pending resolution of the judicial proceedings.²⁶⁹ This justification is inadequate to support staying arbitration, however, because the Supreme Court has ruled twice recently that considerations of judicial economy cannot override the strong national policy reflected in the FAA.²⁷⁰ Under those decisions, it is improper for a court to stay arbitration pending resolution of the judicial proceedings.

Although considerations of judicial economy cannot forestall arbitration under the strong mandate of the FAA, such considerations do argue strongly against letting the arbitration and the judicial proceeding go forward simultaneously. That

listed several factors supporting its conclusion that the arbitrated issues should not be relitigated: the commonality of facts involved in the claims; the procedural fairness of the arbitration proceeding, at which both parties were represented by counsel who made opening and closing statements and at which both parties called witnesses; and the existence of a complete transcript and preservation of all documents. *See id.*

268. This Article argues that Congress has not expressed such a will and that the *Wilko* decision is based on a misreading of the 1933 Act. *See supra* notes 95-98 and accompanying text.

269. *See, e.g., Sennett v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,378, at 97,502-03 (N.D. Ill. Apr. 9, 1980); *Peacock v. Oppenheimer & Co.*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,586-87 (N.D. Ill. Sept. 17, 1979).

270. *See Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 221 (1985) ("The preeminent concern of Congress in passing the [Federal Arbitration] Act was to enforce private agreements into which parties had entered, and that concern requires that we rigorously enforce agreements to arbitrate, even if the result is 'piecemeal' litigation . . ."); *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 20 (1983) (the FAA "requires piecemeal resolution when necessary to give effect to an arbitration agreement") (footnote omitted).

being the case, the only reasonable solution to the problem of ordering is to stay the judicial resolution of nonarbitrable claims pending the outcome of the arbitration proceeding. This solution seems to be the favored one among courts that have faced the issue since *Byrd*.²⁷¹ The solution is an ideal one, given the competing interests at stake. Requiring the parties to arbitrate *and* to litigate is worse than requiring them to litigate all their claims, because it destroys all the advantages of arbitration. The parties are not spared the expense of litigation, the court docket is not any less crowded, and the time involved is even greater. In other words, to require the parties simultaneously to litigate and to arbitrate robs the parties of the benefit of the bargain they made.

On the other hand, staying the court proceeding prevents the plaintiff and defendant from having to be in two places at once. It also makes a settlement short of federal litigation more likely because a party may rethink his stance in light of an impartial arbitrator's view of the case. Courts need not be concerned about collateral estoppel because application of that doctrine is within their discretion.²⁷² Thus, there is a solution to the problem of ordering.

E. THE CONTINUING PROBLEM: HOW FAR SHOULD *WILKO* EXTEND?

The legacy of the *Wilko-Scherk-Byrd* progression pales in comparative importance to the question that continues to perplex the judiciary: How far should the *Wilko* doctrine be extended? *Wilko* itself involved only an express cause of action under the 1933 Act. The principal questions that remain unresolved are whether the *Wilko* doctrine, in light of *Scherk* and *Byrd*, should extend to implied causes of action under the 1933 or 1934 Acts, or to express causes of action under the 1934 Act.

271. See, e.g., *Becker v. Silverman*, 638 F. Supp. 193, 196-97 (S.D.N.Y. 1986); *Bale v. Dean Witter Reynolds, Inc.*, 627 F. Supp. 650, 655 (D. Minn. 1986); *Adams v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,328, at 92,175 (W.D. Okla. Sept. 20, 1985); *Webb v. R. Rowland & Co.*, 613 F. Supp. 1123, 1124 (E.D. Mo. 1985). But see *Cummings v. A.G. Edwards & Sons, Inc.*, 637 F. Supp. 132, 133 (M.D. La. 1986) (refusing to stay federal action pending arbitration of state claims).

272. See *supra* notes 264-68 and accompanying text.

1. Applying *Wilko* to Implied Causes of Action Under the 1934 Act

The Court in both *Scherk*²⁷³ and *Byrd*²⁷⁴ seemed to speak strongly against applying the *Wilko* doctrine to implied causes of action under the 1934 Act. Although some courts have continued to hold that a party may not be held to her agreement to arbitrate such claims,²⁷⁵ a number of cases have reached a contrary conclusion.²⁷⁶ In fact, in the *Byrd* case on remand, the

273. See *supra* notes 118-23 and accompanying text.

274. See *supra* notes 182-88 and accompanying text.

275. See *Jacobson v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 797 F.2d 1197, 1200-02 (3d Cir.), *petition for cert. filed*, 55 U.S.L.W. 3259 (U.S. Sept. 25, 1986) (No. 86-487); *Conover v. Dean Witter Reynolds, Inc.*, 794 F.2d 520, 522-27 (9th Cir.), *petition for cert. filed*, 55 U.S.L.W. 3159 (U.S. Aug. 24, 1986) (No. 86-321); *Miller v. Drexel Burnham Lambert, Inc.*, 791 F.2d 850, 854 (11th Cir. 1986); *King v. Drexel Burnham Lambert, Inc.*, 796 F.2d 59, 60 (5th Cir.), *petition for cert. filed*, 55 U.S.L.W. 3153 (U.S. Aug. 25, 1986) (No. 86-282); *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94, 96-98 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44); *Intre Sport, Ltd. v. Kidder, Peabody & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,714, at 93,473 (S.D.N.Y. Apr. 21, 1986); *Shapiro v. Merrill Lynch & Co.*, 634 F. Supp. 587, 593 (S.D. Ohio 1986); *Scharp v. Cralin & Co.*, 617 F. Supp. 476, 479-80 (S.D. Fla. 1985); *Webb*, 613 F. Supp. at 1124.

Although the SEC now takes the position that *Wilko* should be overruled, and that arbitration clauses between brokers and investors should be enforced, the SEC continues to deny there is any distinction between express and implied rights of action on the issue of arbitrability. SEC Amicus Brief, *supra* note 21, at 2, 7, 21-26.

276. See, e.g., *Phillips v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 795 F.2d 1393, 1397-98 (8th Cir.), *petition for cert. filed*, 55 U.S.L.W. 3296 (U.S. Oct. 7, 1986) (No. 86-578); *Steinberg v. Illinois Co.*, 635 F. Supp. 615, 618-19 (N.D. Ill. 1986); *Fisher v. Prudential-Bache Sec., Inc.*, 635 F. Supp. 234, 236 (D. Md. 1986); *Sacks v. Dean Witter Reynolds Inc.*, 627 F. Supp. 377, 279 (C.D. Cal. 1985); *Geller v. Nasser*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,409, at 92,512 (C.D. Cal. Nov. 18, 1985); *Prawer v. Dean Witter Reynolds, Inc.*, 626 F. Supp. 642, 646 (D. Mass. 1985); *Jope v. Bear Stearns & Co.*, 632 F. Supp. 140, 143 (N.D. Cal. 1985); *Peele v. Kidder, Peabody & Co.*, 620 F. Supp. 61, 63 (W.D. Mo. 1985); *Ross v. Mathis*, 624 F. Supp. 110, 115-16 (N.D. Ga. 1985); *Land v. Dean Witter Reynolds, Inc.*, 617 F. Supp. 52, 54 (E.D. Va. 1985); *Marx v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,311, at 92,112 (C.D. Cal. Aug. 23, 1985); *West v. Drexel Burnham Lambert, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,327, at 92,172 (W.D. Wash. Aug. 15, 1985); *Hashemi v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 642 F. Supp. 376, 380 (N.D. Ga. 1985); *Jarvis v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146, 1152 (D. Vt. 1985); *Colangelo v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,365, at 92,330 (M.D. Fla. July 23, 1985); *Niven v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,257, at 91,796 (M.D. Fla. June 27, 1985); *Finn v. Davis*, 610 F. Supp. 1079, 1081-82 (S.D. Fla. 1985); *Rai-ford v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,269, at 91,856 (N.D. Ga. May 16, 1985).

district court read the Supreme Court's ruling to require ordering the plaintiff's 10b-5 claim to arbitration as agreed.²⁷⁷ The circuits are split on this point,²⁷⁸ and the Supreme Court has agreed to resolve the split.²⁷⁹ As has been noted,²⁸⁰ some courts have not followed the suggestions of *Byrd* and *Scherk* because they read the suggestions as mere dicta that does not overrule settled authority in their respective circuits.²⁸¹ Other lower courts have not been so reticent to reject earlier authority in their circuits in light of *Byrd*.²⁸²

Aside from the apparently imminent Supreme Court ruling that implied actions under the 1934 Act are arbitrable,²⁸³ and in addition to the support for such a ruling in the better-reasoned lower court opinions,²⁸⁴ compelling analytical reasons justify enforcing agreements to arbitrate implied actions under the 1934 Act.²⁸⁵ The FAA's strong endorsement of enforcing agreements to arbitrate and the policy that all doubts concerning the

The continuing vitality of many of these cases is called into question by subsequent rulings from the various courts of appeals. See *infra* note 278.

277. See *Byrd v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,225, at 91,641 (S.D. Cal. July 8, 1985).

278. The Second, Third, Fifth, Ninth, and Eleventh Circuits have ruled that implied claims under the 1934 Act cannot be compelled into arbitration. See *Jacobson*, 797 F.2d at 1202; *Conover*, 794 F.2d at 527; *Miller*, 791 F.2d at 854; *King*, 796 F.2d at 60; *McMahon*, 788 F.2d at 98. The First and Eighth Circuits have ruled that such claims may be compelled into arbitration. See *Page v. Moseley, Hallgarten, Estabrook & Weeden, Inc.*, 806 F.2d 291 (1st Cir. 1986); *Phillips*, 795 F.2d at 1399.

279. See *McMahon*, 788 F.2d 94 (2d Cir.), *cert. granted*, 107 S. Ct. 60 (1986) (No. 86-44).

280. See, e.g., *Shotto v. Laub*, 632 F. Supp. 516, 524-25 (D. Md. 1986); *Prawer*, 626 F. Supp. at 646 n.1.

281. See, e.g., *Miller*, 791 F.2d at 854; *McMahon*, 788 F.2d at 98; *Intre Sport, Ltd. v. Kidder, Peabody & Co.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,714, at 93,472-73 (S.D.N.Y. Apr. 21, 1986); *Scharp v. Cralin & Co.*, 617 F. Supp. 476, 479 (S.D. Fla. 1985).

282. See, e.g., *Steinberg v. Illinois Co.*, 635 F. Supp. 615, 618 (N.D. Ill. 1986) (stating that the court was "convinced" that the Seventh Circuit would not follow earlier authority holding 1934 Act claims arbitrable).

283. As noted above, *supra* notes 134-37 and accompanying text, five sitting Supreme Court Justices have already expressed disapproval of extending *Wilko* to 1934 Act claims. These proclivities of individual Justices have not escaped the notice of lower courts. See, e.g., *Halliburton & Assocs. v. Henderson, Few & Co.*, 774 F.2d 441, 445 (11th Cir. 1985) (refusing to grant plaintiff leave to amend its complaint to include claims under the 1933 Act, by which plaintiff hoped to defeat defendant's motion to compel arbitration between the parties—both municipal bond dealers—and thereby refusing to extend *Wilko* to 1934 Act claim, noting that Justices White and Stevens have questioned such an extension).

284. See *supra* note 276 and accompanying text.

285. Commentators are beginning to come around on this issue. See, e.g.,

enforceability of such clauses, including analytical doubts, are to be resolved in favor of arbitration under the argument for enforcing such agreements.²⁸⁶ Furthermore, Justice White was correct when he noted in *Byrd* that *Wilko*'s reasoning cannot be mechanically applied to implied actions under the 1934 Act.²⁸⁷ The *Wilko* Court considered it crucial that in enacting the 1933 Act Congress intended plaintiffs to have a wide choice of judicial forums,²⁸⁸ as the Supreme Court has since observed.²⁸⁹ Congress intended plaintiffs suing under the 1934 Act to have much more limited judicial access.²⁹⁰

Furthermore, the *Wilko* Court emphasized that in section 12(2) Congress gave plaintiffs a special right, not available at common law, to sue for misrepresentations without having to prove scienter. Implied causes of action under the 1934 Act do not invoke a congressionally given right at all; rather, the right to sue is judicially created. As the Supreme Court recently said in a nonsecurities case, a party "should be held to [its agreement to arbitrate] unless Congress itself has evinced an intention to preclude a waiver of judicial remedies for the statutory rights at issue."²⁹¹ For implied causes of action, Congress has not provided judicial remedies at all. It necessarily follows that Congress has not evinced an intention to preclude a waiver of any judicial remedies.²⁹²

Thus, even if one accepts the dubious proposition that *Wilko* was rightly decided, agreements to arbitrate claims that arise because of implied causes of action under the 1934 Act should be enforced.

2. Applying *Wilko* to Express Causes of Action Under the 1934 Act

The argument for the enforceability of agreements to arbitrate express causes of action under the 1934 Act is less strong

Katsoris, *supra* note 9, at 300 (arguing against applying *Wilko* doctrine to 1934 Act claims).

286. See *supra* notes 21-38 and accompanying text.

287. *Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 224 (1985) (White, J. concurring).

288. *Wilko v. Swan*, 346 U.S. 427, 431-32 (1953).

289. See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 513-14 (1974).

290. See 15 U.S.C. § 78aa (1982) (providing for exclusive federal jurisdiction).

291. See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3355 (1985); *Ross v. Mathis*, 624 F. Supp. 110, 116 (N.D. Ga. 1985).

292. See *Mitsubishi Motors Corp.*, 105 S. Ct. at 3355; *Ross*, 624 F. Supp. at 116.

but still persuasive. Cases involving the enforceability of agreements to arbitrate 1934 Act claims consist almost exclusively of 10b-5 claims,²⁹³ for which the judicial remedy is implied.²⁹⁴ The 1934 Act, however, does contain express provisions for civil liability in cases of misleading filings with the SEC,²⁹⁵ manipulation of securities prices²⁹⁶ and insider short-swing profits.²⁹⁷ Many cases seem to say that parties can enforce agreements to arbitrate disputes under those sections of the 1934 Act. Those cases, however, involved 10b-5 claims, and the courts speak of 1934 Act claims as though express and implied causes are indistinguishable on the arbitrability issue.²⁹⁸ Such a supposition is dangerous, however, because for express causes of action under the 1934 Act, one of the primary justifications for not extending the *Wilko* decision—that Congress has not provided a judicial remedy not to be waived²⁹⁹—is not present. Nonetheless, independent reasons support enforcing an agreement to arbitrate disputes under any section of the 1934 Act, even if *Wilko* was rightly decided. The most important independent justification is the degree to which *Wilko* relied on the expanded forum choice for 1933 Act claims—forum choices not provided for in the 1934 Act.³⁰⁰

Because the types of transactions that would lead to a claim under one of the express causes of action afforded by the 1934 Act are not the type that typically would occur under a written agreement, motions to arbitrate such claims will be rare. When presented with such a motion, however, courts should not hesitate to order the claim to arbitration even

293. See, e.g., *McMahon v. Shearson/American Express, Inc.*, 788 F.2d 94 (2d Cir.), cert. granted, 107 S. Ct. 60 (1986) (No. 86-44); *Steinberg v. Illinois Co.*, 635 F. Supp. 615 (N.D. Ill. 1986); *Shapiro v. Merrill Lynch & Co.*, 634 F. Supp. 587 (S.D. Ohio 1986); *Sacks v. Dean Witter Reynolds Inc.*, 627 F. Supp. 377 (C.D. Cal. 1985); *Colangelo v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,365 (M.D. Fla. July 23, 1985).

294. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730 (1975).

295. 15 U.S.C. § 78r (1982).

296. *Id.* § 78i.

297. *Id.* § 78p(b).

298. See, e.g., *Jope v. Bear Stearns & Co.*, 632 F. Supp. 140, 143 (N.D. Cal. 1985) (holding the 10b-5 claim subject to arbitration in light of the "trend towards permitting arbitration of 1934 Act claims"); *Ross v. Mathis*, 624 F. Supp. 110, 115 (N.D. Ga. 1985) (ignoring the express provisions for civil liability contained in the 1934 Act and stating that the 1934 Act provides only for implied rights of action).

299. See *supra* notes 291-92 and accompanying text.

300. See *supra* notes 288-90 and accompanying text.

though the case for arbitration is not as strong as for implied actions under the 1934 Act.

3. Applying *Wilko* to Implied Rights of Action Under the 1933 Act

Section 17(a) of the 1933 Act³⁰¹ provides a counterpart to Rule 10b-5 promulgated under the 1934 Act.³⁰² Although Congress has not provided a judicial remedy for violations of section 17(a), many courts have implied a private cause of action.³⁰³ Careful analysis suggests that a party should be able to compel arbitration of a claim under section 17(a), and recent decisions indicate that some courts agree.³⁰⁴

All the arguments favoring compelling arbitration of implied actions under the 1934 Act³⁰⁵ apply, except that section 17(a) is found in the 1933 Act, where Congress has provided a multitude of possible forums from which a plaintiff may choose.³⁰⁶ The broad choice of forums was one reason the *Wilko* Court held there could be no compulsory arbitration of claims under section 12(2) of the 1933 Act.³⁰⁷ The *Wilko* chain

301. 15 U.S.C. § 77q (1982).

302. Section 17(a), as codified, is almost identical to Rule 10b-5. Compare the language of Rule 10b-5, quoted *supra* note 112, with the following:

It shall be unlawful for any person in the offer or sale of any securities . . .

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Act of 1933 § 17(a), 15 U.S.C. § 77q (1982).

303. See, e.g., *Berger v. Bishop Inv. Corp.*, 695 F.2d 302, 305 (8th Cir. 1982); *Stephenson v. Calpine Conifers II, Ltd.*, 652 F.2d 808, 815 (9th Cir. 1981); *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978). But see *Landry v. All Am. Assurance Co.*, 688 F.2d 381, 389-91 (5th Cir. 1982) (no private cause of action under § 17(a)); *Kaufman v. Magid*, 539 F. Supp. 1088, 1097-98 (D. Mass. 1982) (same). Professor Loss has come down strongly on the side disapproving a private cause of action under § 17(a). See L. LOSS, *supra* note 69, at 1148 ("Will § 17(a) of the 1933 Act support a private right of action? . . . If *anything* in the 1933 Act can be stated categorically, the answer should be no.").

304. See, e.g., *Brener v. Becker Paribas Inc.*, 628 F. Supp. 442, 449 (S.D.N.Y. 1985) (holding that claims under § 17(a) must be arbitrated pursuant to the agreement of the parties).

305. See *supra* notes 273-92 and accompanying text.

306. See 15 U.S.C. § 77v (1982) (providing for concurrent state and federal jurisdiction over § 77 claims).

307. See *supra* notes 85-86 and accompanying text.

of reasoning is broken for section 17(a) claims by the absence of one of the considerations the *Wilko* Court found crucial. In *Wilko*, the Court noted that Congress had provided an express remedy in section 12(2) and had provided a broad choice of forums in section 22.³⁰⁸ It was this *combination* of sections that led the Court to the result it reached.³⁰⁹ For claims under section 17(a), there is no congressional mandate that a plaintiff be accorded the forum choice contained in the 1933 Act, because Congress has not provided for private causes of action at all under that section. Rather, the courts have provided the cause of action. For that reason the courts cannot say about section 17(a), as the Court in *Wilko* did about section 12(2), that Congress has given plaintiffs a remedy and a choice of judicial forums. The same would hold true for any other implied causes of action under the 1933 Act.³¹⁰

A second reason for compelling arbitration of claims under section 17(a) stems from the similarity between section 17(a) and Rule 10b-5.³¹¹ The holding that 10b-5 claims must be arbitrated³¹² would be eviscerated if plaintiffs could simply state their claim as one under section 17(a) instead and thereby avoid having to arbitrate pursuant to their agreement.³¹³

308. *Wilko v. Swan*, 346 U.S. 427, 431 (1953).

309. *See Dean Witter Reynolds Inc. v. Byrd*, 470 U.S. 213, 224 (1985) (White, J., concurring) (noting that the *Wilko* Court relied on three interconnected statutory provisions in holding arbitration agreements unenforceable with regards to claims under § 12(2) of the 1933 Act: § 14, which voids stipulations binding persons acquiring securities to waive compliance with any provision of the Act; § 12(2), which creates a right to recover for misrepresentation that is substantially different from the common law; and § 22, which allows suit in any state or federal court of competent jurisdiction and provides for nationwide service of process).

310. An additional question that arises is whether the *Wilko* doctrine should be extended to implied causes of action under rules promulgated by the Federal Reserve Board or the numerous SROs. Courts have found implied causes of action for dozens of statutory and regulatory provisions relating to securities. *See generally* 2 FEDERAL SECURITIES CODE § 1722 (1980) (listing 31 statutory and regulatory provisions for which courts have implied causes of action). All the arguments in favor of enforcing agreements to arbitrate implied causes of action under Rule 10b-5 are applicable to any implied causes of action under any statutory or regulatory provision except the 1933 Act. *See supra* notes 273-92 and accompanying text. For these reasons, courts should not hesitate to enforce arbitration clauses that apply to securities claims made pursuant to the doctrine of implied causes of action.

311. *See supra* note 302 and accompanying text. *See also Brener v. Becker Paribas Inc.*, 628 F. Supp. 442, 449 (S.D.N.Y. 1985) (noting that § 17(a) and Rule 10b-5 are substantially identical).

312. *See cases cited supra* note 276.

313. Evisceration may be unavoidable, however, in light of recent cases

4. Rule 15c2-2 and the Effect of an Improvidently Made Rule

One illustration of the dynamism that permeates this subject is the rapidity with which the law concerning the enforceability of arbitration clauses has changed in the past few years. Whereas only a few years ago nearly all courts assumed that implied actions under the 1934 Act were subject to the *Wilko* doctrine,³¹⁴ many courts now take the contrary position.³¹⁵ Even when courts agreed that 1934 Act claims were not arbitrable, some broker-dealers nevertheless continued to include in some of their customer agreements arbitration clauses purporting to cover all disputes.³¹⁶ That practice created some concern within the SEC that investors might be deceived into believing that they had irrevocably waived their right to sue in federal court for violations of the 1934 Act.³¹⁷ The SEC's concern led it, in 1979, to promulgate Release No. 15,984, in which the SEC stated that such a practice was misleading and questioned its advisability under the antifraud provisions of the 1934 Act.³¹⁸ Although one court refused to enforce an arbitration agreement that did not distinguish between arbitrable and unarbitrable claims,³¹⁹ that case was later overruled,³²⁰ and courts now recognize that the Release can have no effect on the enforceability of an arbitration clause.³²¹

holding that a mere broker can be liable as a "seller" under § 12(2) of the 1933 Act. *See, e.g.,* Lukovich v. E.F. Hutton & Co., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,701, at 93,412-13 (D. Or. Apr. 21, 1986); *Frogner v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,504, at 96,927-28 (N.D. Cal. Sept. 26, 1983). If the same types of practices that would lead to broker liability under 10b-5 would also support an action under § 12(2), a plaintiff could ensure the application of the *Wilko* decision by suing under § 12(2) instead. Section 12(2) could prove to be a much more hospitable section for plaintiffs, because it shifts the burden of proving lack of scienter onto the defendant. *See* 15 U.S.C. § 77l (1982).

314. *See* cases cited *supra* note 104.

315. *See supra* note 276 and accompanying text.

316. *See* Exchange Act Release No. 15,984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,975 (July 2, 1979) ("Some broker-dealer customer agreements appear to bind customers to arbitrate all future disputes with a broker-dealer.").

317. *See id.* at 81,978.

318. *See id.*

319. *Bear, Stearns & Co. v. Weiss*, 104 Misc. 2d 876, 878, 429 N.Y.S.2d 156, 158 (1980).

320. *See Harris v. Shearson Hayden Stone, Inc.*, 82 A.D.2d 87, 89-90, 441 N.Y.S.2d 70, 72-3 (1981), *aff'd*, 56 N.Y.2d 627, 435 N.E.2d 1097, 450 N.Y.S.2d 482 (1982).

321. *See, e.g., Jope v. Bear Stearns & Co.*, 632 F. Supp. 140, 143 (N.D. Cal. 1985).

The SEC, however, did not stop with the one release. Because the use of broad arbitration clauses continued,³²² the SEC in 1983 promulgated Rule 15c2-2 under the authority of section 15(c)(2) of the 1934 Act.³²³ This rule made it a fraudulent act, for purposes of section 15(c)(2), for a broker-dealer to use a form of agreement that purported to bind the customer to arbitration of claims under the 1934 Act.³²⁴ The SEC promulgated the rule on the assumption that an agreement to arbitrate claims under the 1934 Act is void.³²⁵ Despite the change in the judicial attitude after *Byrd*,³²⁶ the rule remains, raising the question of the rule's current effect. The short answer is that the rule is of no effect to the extent it is premised on an erroneous assumption of law.

Rule 15c2-2 is interpretive, designed to give meaning to the legislative proscription of fraudulent and manipulative practices contained in section 15(c)(2) and, as such, does not have the force of law.³²⁷ It merely represents public notice of the SEC's construction of the statute, which is all-important in the case of rules promulgated under section 15(c)(2), because only the SEC can enforce the section.³²⁸ Even if the rule is substantive, however, and therefore has the force of law,³²⁹ it cannot supersede the judicial decisions holding 1934 Act claims arbitrable.³³⁰ Moreover, Rule 15c2-2 was not intended to affect the

322. See 48 Fed. Reg. 53,404 (1983) (SEC found many brokers continued to use arbitration clauses despite contrary law which prohibits this language). The rule following this explanation is codified as amended at 17 C.F.R. § 240.15c2-2 (1986).

323. 17 C.F.R. § 240.15c2-2 (1986) (promulgated pursuant to the Securities Exchange Act of 1934, § 15(c)(2), 15 U.S.C. § 78o(c)(2) (1982)). Section 15(c)(2) proscribes fraudulent and manipulative practices on the part of broker-dealers and authorizes the SEC to promulgate rules setting forth the acts that are fraudulent or manipulative.

324. 17 C.F.R. § 240.15c2-2 (1986).

325. See Exchange Act Release No. 20,397, 48 Fed. Reg. 53,404 (1983) (codified as amended at 17 C.F.R. § 240.15c2-2 (1986)) ("statutory and case law clearly render unenforceable agreements to arbitrate future disputes between broker-dealers and their public customers"). The SEC now confesses that this erroneous view motivated the promulgation of Rule 15c2-2 and the issue of Release No. 15,984. SEC Amicus Brief, *supra* note 21, at 18 n.13.

326. See *supra* notes 275-76 and accompanying text.

327. See *Guardian Fed. Sav. & Loan Ass'n v. Federal Sav. & Loan Ins. Corp.*, 589 F.2d 658, 664-65 (D.C. Cir. 1978); *Washington Fed. Sav. & Loan Ass'n v. Federal Home Loan Bank Bd.*, 526 F. Supp. 343, 383 (N.D. Ohio 1981).

328. See *Shotto v. Laub*, 632 F. Supp. 516, 518 n.2 (D. Md. 1986) (There are no private causes of action for violation of Rule 15c2.).

329. See *Guardian Fed. Sav. & Loan Ass'n*, 589 F.2d at 664; *Washington Fed. Sav. & Loan Ass'n*, 526 F. Supp. at 383.

330. See 5 U.S.C. § 706 (1982) (courts must set aside substantive rules to the

substantive rights of a customer or a broker to a judicial hearing or arbitration. Rather, it was procedural in nature, designed to ensure notice to the customer of his rights under the law.³³¹

Because the law has changed since the rule was promulgated,³³² courts recognize that a broker's use of an arbitration clause apparently in violation of Rule 15c2-2 cannot render the clause unenforceable when substantive law mandates enforcement.³³³ That is not to say, however, that the rule has had no effect. In an attempt to comply with the SEC directive, some brokers have inserted language into their customer agreements stating that the agreement to arbitrate does not affect the customer's right to a judicial hearing on claims under the securities laws.³³⁴ This practice has led some courts to refuse to compel arbitration of claims under the 1934 Act.³³⁵ Those decisions are clearly sound, because it would be unfair to force a customer to arbitrate a claim that his contract suggests will not be arbitrated. Such decisions, however, put the broker in an unfair bind. She must either flout an SEC rule, a poor idea even if the rule was improvidently promulgated, or forego her right to arbitrate claims which the courts have said are arbitra-

extent those rules exceed statutory authority or are otherwise not in conformity with law).

331. See *Shotto*, 632 F. Supp. at 527; *Finkle & Ross v. A.G. Becker Paribas, Inc.*, 622 F. Supp. 1505, 1510 (S.D.N.Y. 1985).

332. See *supra* notes 275-76 and accompanying text.

333. See, e.g., *Fisher v. Prudential-Bache Sec., Inc.*, 635 F. Supp. 234, 236-37 (D. Md. 1986) (finding case law following promulgation of Rule 15c2-2 favors arbitration); *Finkle & Ross*, 622 F. Supp. at 1510 ("Plaintiffs do not give up their substantive rights under federal laws by being required to arbitrate their dispute."); *Colangelo v. Dean Witter Reynolds, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,365, at 92,330 (M.D. Fla. July 23, 1985) (finding that the state of the law at the time Rule 15c2-2 was promulgated was no longer the current state of the law).

334. See, e.g., *Scharp v. Cralin & Co.*, 617 F. Supp. 476, 479 (D. Fla. 1985) (arbitration clause read in part: "This provision is not intended to waive any rights which the undersigned [customer] may have to elect to take legal action as to any matter or claim arising under the Federal Securities Laws."); *Shotto*, 632 F. Supp. at 519 (similar provision).

335. See, e.g., *Scharp*, 617 F. Supp. at 479-80 (holding that plaintiff did not waive right to sue by signing agreement to arbitrate); *Hammerman v. Peacock*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,239, at 91,704-05 (D.D.C. July 31, 1985) (finding that the agreement clause stating the customer had a right to judicial recourse for federal securities law claims indicated an intent not to submit any valid claim under the federal securities laws to arbitration). But see *Shotto*, 632 F. Supp. at 526-27 (stating that although agreement contained a clause limiting arbitration, 1934 Act claims should be arbitrated in light of *Byrd* and its progeny).

ble. The solution to this conundrum is to repeal the rule or to modify it to require notice only that express causes of action under the 1934 Act cannot be compulsorily arbitrated.

IV. WHY NOT ARBITRATE SECURITIES DISPUTES?

This Article has attempted to sort through the morass of existing law concerning the enforceability of arbitration agreements in the securities industry. This final Part examines the larger question that arises: Is arbitration a good and fair way to resolve differences between brokers and their customers?³³⁶ The historical objections to arbitrating such claims are based on myths of two types: myths about the arbitration agreements entered into between brokers and customers and myths about the arbitration proceedings themselves. Once these myths are refuted, no objection remains to compelling arbitration if the parties have validly agreed to arbitrate.

A. DISPELLING THE MYTHS ABOUT ARBITRATION AGREEMENTS

1. Myth #1: Arbitration Clauses are Adhesion Contracts That Customers Must Sign if They Want Access to the Securities Markets.

An adhesion contract is generally more of an ultimatum than an agreement. A contract is considered to be an adhesion contract when a provision, usually in a standard form contract drafted by a party in a position to dictate terms, is presented to a second party who has no choice but to accept it.³³⁷ The fact that an arbitration clause is contained in an adhesion contract does not necessarily render it unenforceable,³³⁸ but it may make enforcement difficult as a practical matter.³³⁹

Courts and commentators simply assume, however, without empirical evidence, that arbitration clauses are presented to

336. The topic of the propriety of arbitration of claims between brokers is not discussed in this section; most people would agree that there is nothing wrong with compelling brokers to arbitrate their disputes if they have so agreed.

337. See Katsoris, *supra* note 9, at 306.

338. See *id.* at 306-07; see also *Vernon v. Drexel Burnham & Co.*, 52 Cal. App. 3d 706, 713, 125 Cal. Rptr. 147, 151 (1975) (rejecting customer's argument that broker's arbitration clause was unenforceable as an adhesion contract).

339. See Wright, *Arbitration Clauses in Adhesion Contracts*, *ARB. J.*, June 1978, at 41, 42 (court faces dilemma of deferring to public policy favoring arbitration or to interest in ensuring voluntary agreements).

investors on a take-it-or-leave-it basis³⁴⁰ and that brokers uniformly force such clauses on their customers.³⁴¹ These critics then suggest that the inequality of bargaining power between the parties makes the waiver of judicial remedies suspect.³⁴²

The most obvious problem with such reasoning is that it proves too much. As stated, the argument would work to invalidate *all* arbitration clauses in contracts between persons of disparate bargaining power.³⁴³ The second problem is that the FAA is designed to guard against such suspect waivers of judicial remedies. No arbitration clause may be enforced if general principles of contract law suggest it should not be enforced.³⁴⁴ Contract law provides circumstances under which adhesion contracts will not be enforced.³⁴⁵ Arbitration clauses are no different from any other contractual provision. If a party feels it is unfair to hold him to the agreement to arbitrate, an argument based on general contract law would be called for.³⁴⁶

340. In *Wilko*, Justice Frankfurter criticized the majority on this basis, noting that there was nothing in the record to suggest that the customers had no choice but to sign the agreement containing the arbitration clause. See *Wilko v. Swan*, 346 U.S. 427, 440 (1953) (Frankfurter, J., dissenting).

341. See, e.g., H.R. DOC. NO. 95, 88th Cong., 1st Sess. 390-91 (1963); Exchange Act Release No. 15,984 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,976 (July 2, 1979) (stating that broker-dealers require customers to enter agreements containing arbitration clauses prior to opening an account).

342. See, e.g., Sterk, *supra* note 95, at 518 ("The public policy involved when one party is in a position to impose an arbitration clause on the other is a basic one: No one should be deprived of access to the courts unless that party has satisfactorily demonstrated a willingness to give up such access.").

343. This problem was recognized by Professor Stewart E. Sterk, but he attempts to justify it by noting that "securities agreements as a class tend to involve" inequality of bargaining power, whatever that means. See *id.* at 517.

344. See 9 U.S.C. § 2 (1982).

345. See Katsoris, *supra* note 9, at 306-07 (stating that courts will not enforce adhesion contracts that are not within the weaker party's reasonable expectations or are unduly oppressive).

346. One contract argument frequently tried but rarely successful is that the agreement was secured by the broker through fraud in the inducement. Courts generally hold, however, that fraud in the inducement of the agreement as a whole can be determined by the arbitrator. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc., v. Haydu*, 637 F.2d 391, 398 (5th Cir. 1981). Only fraud in the inducement of the arbitration clause itself will suffice to avoid arbitration. See *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 403-04 (1967); *Miller v. Drexel Burnham Lambert, Inc.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,783, at 93,858 (11th Cir. June 17, 1986); *Jarvis v. Dean Witter Reynolds, Inc.*, 614 F. Supp. 1146, 1148 (D. Vt. 1985). The corollary holding in cases where exchange members sue other exchange members is that if the member was induced to join the exchange fraudulently, the arbitration agreement contained in the exchange rules is ineffective. See *Laupheimer v. McDonnell & Co.*, 500 F.2d 21, 25 (2d Cir. 1974) (holding that

Moreover, not all brokers require customers to sign arbitration agreements as a condition to access to the market. Evidence suggests that this myth has never been true. A study conducted in 1953, the year *Wilko* was decided, surveyed twenty margin agreements in use then and found that a significant proportion of them did not contain arbitration clauses.³⁴⁷ It remains true today that a customer need not sign an arbitration agreement to trade in securities. A survey of four of the largest national brokerage houses shows that only two require any agreement at all before a person begins trading in the markets.³⁴⁸ Only one of the four uses an arbitration clause for cash customers.³⁴⁹ All four firms require written agreements for margin and options transactions, but only two of them use arbitration clauses in connection with their agreements.³⁵⁰

Although the sample included in this survey was small, the findings suggest clearly that a customer has a choice; she need not sign an arbitration agreement to trade in the stock, bond, or even the options markets.³⁵¹ The customer has a choice between a full service broker and a discount broker who do not use arbitration clauses. Furthermore, nothing suggests that, in

the plaintiff, as a member and as a stockholder, is entitled not to arbitrate). If a plaintiff alleges fraud in the inducement of the arbitration clause itself, there will be an adjudication of that allegation before a decision is made whether the claim should be sent to arbitration. See *Wick v. Atlantic Marine, Inc.*, 605 F.2d 166, 168 (5th Cir. 1979).

347. See Note, *supra* note 203, at 987 n.11. That survey did not report the incidence of arbitration clauses for strictly cash customers. A cash customer is obligated to pay for her securities in full on or before the "settlement date," which is usually five days from the date of purchase. A person with a margin account need only pay a percentage of the purchase price by the settlement date; the rest is lent to her by the broker. Because of this "leverage," the risk of loss is substantially greater for a person making full use of available margin. Thus, margin accounts are for the more sophisticated investor.

348. Charles S. Schwab & Co., the nation's largest discount brokerage firm, requires a written agreement signed by the customer, as does Merrill Lynch, Pierce, Fenner & Smith. E.F. Hutton & Co., and A.G. Edwards & Sons, however, do not.

349. Merrill Lynch, Pierce, Fenner & Smith uses an arbitration clause, Charles Schwab & Co. does not.

350. The options and margin agreements of Merrill Lynch, Pierce, Fenner & Smith and A.G. Edwards & Sons contain arbitration clauses; similar agreements used by Charles Schwab & Co. and E.F. Hutton & Co. do not.

351. Professor Constantine N. Katsoris, as a result of his own informal survey, came to the same conclusion. He found that, generally, a customer must sign an agreement before opening a margin, options, or commodity account, but that written agreements in cash accounts are much less prevalent. See Katsoris, *supra* note 9, at 292 n.86. Professor Katsoris does not report what percentage of the written agreements contained arbitration clauses.

an industry as competitive as the brokerage business, a firm would reject a customer's account if the customer insisted on deleting the arbitration clause.

In short, arbitration clauses are not adhesion contracts. If a customer wants to trade in the markets without waiving his right to sue in court, he can do so. If that customer enters into an agreement to arbitrate disputes, that is a choice he has made freely.³⁵²

2. Myth #2: Arbitration Clauses Used by Brokers Force Customers to Arbitrate on the Broker's Home Court.

Critics of enforcing arbitration clauses often contend that in arbitrations conducted pursuant to a broker's arbitration clause, the arbitrators are affiliated with the securities industry and, therefore, less likely to give the customer a fair hearing.³⁵³ One commentator has suggested that investors are "understandably suspicious" because arbitrators are "heavily oriented toward the [securities] industry."³⁵⁴ These commentators are mistaken about the arbitration panels for which brokers' agreements customarily provide.

Nearly all arbitration agreements used by brokerage firms give the investor a choice among various arbitration panels. The industry standard reads as follows:

Any controversy between you [the broker] and the undersigned [customer] arising out of or relating to this contract or the breach thereof, shall be settled by arbitration, in accordance with the rules, then obtaining, of either the Arbitration Committee of the Chamber of Commerce of the State of New York, or the American Arbitration Association, or the Board of Arbitration of the New York Stock Exchange, as the undersigned [customer] may elect.³⁵⁵

352. If the customer neglects to read the agreement, that should not be a defense to a motion to compel arbitration. *See, e.g., Hicks v. Ocean Drilling & Exploration Co.*, 512 F.2d 817, 825-26 (5th Cir. 1975) (finding that a party who signs without reading an agreement cannot use ignorance as a defense), *cert. denied*, 423 U.S. 1050 (1976).

353. *See, e.g.,* Exchange Act Release No. 13,470, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136, at 87,906 (Apr. 26, 1977).

354. *See* Comment, *supra* note 203, at 123. *See also id.* at 129 ("The institutional framework of securities industry arbitration . . . [results in] a substantial denial of the rights and protections granted investors by the antifraud provisions.").

355. *Id.* at 125 (quoting 8 C. NICHOLS, CYCLOPEDIA OF LEGAL FORMS ANNOTATED § 8.1710, at 921 (1973) as the most widely used arbitration clause). Clauses substantially identical to the Nichols form are widely used. *See, e.g., Wilko v. Swan*, 346 U.S. 427, 432 n.15 (1953); *Kavit v. A.L. Stamm & Co.*, 491

The customer therefore has the choice of three different arbitration panels, only one of which is a member of the securities industry. The other two are independent, nonprofit organizations with no ties to the securities industry at all. Moreover, an arbitration under the auspices of the New York Stock Exchange must be conducted by a group of arbitrators, the majority of whom must be from outside the securities industry if the customer so elects.³⁵⁶

The modern trend is to give the investor even more choice. Recent cases show that investors are generally asked to choose between the American Arbitration Association and one of a number of industry organizations that have arbitration departments.³⁵⁷ In each of those industry organizations, the arbitration rules provide that the customer may elect to have her case decided by an arbitration panel consisting of a majority of arbitrators from outside the securities industry.³⁵⁸ Although some arbitration clauses provide the customer with a shorter list from which to choose,³⁵⁹ apparently all arbitration clauses now

F.2d 1176, 1178 n.2 (2d Cir. 1974); *Wise v. Kidder, Peabody & Co.*, 596 F. Supp. 1391, 1396 (D. Del. 1984); *Seymour v. Bache & Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,402, at 99,056 (S.D.N.Y. Jan. 14, 1976); *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21, 24 (E.D. Cal. 1974); *Berens v. Bache & Co.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,387, at 95,337 (S.D.N.Y. Jan. 31, 1974); *Shearson, Hammill & Co. v. Vouis*, 247 So. 2d 733, 734 (Fla. Dist. Ct. App.), *cert. denied*, 253 So. 2d 444 (Fla. 1971). Although the contract purports to be between the customer and the brokerage firm, the customer cannot avoid arbitration simply by suing the individual broker instead; the arbitration clause applies to the individual broker on a theory of agency. *See Berman v. Dean Witter & Co.*, 44 Cal. App. 3d 999, 1003, 119 Cal. Rptr. 130, 133 (1975).

356. *See infra* notes 375-76 and accompanying text.

357. *See, e.g., Steinberg v. Illinois Co.*, 635 F. Supp. 615, 617 n.1 (N.D. Ill. 1986) (customer given choice between AAA or any stock, option, or commodity exchange of which defendant was a member); *Shotto v. Laub*, 632 F. Supp. 516, 519 (D. Md. 1986) (customer given choice between AAA, New York Stock Exchange, American Stock Exchange or Nat'l Ass'n of Sec. Dealers); *Cunningham v. Dean Witter Reynolds, Inc.*, 550 F. Supp. 578, 579 (E.D. Cal. 1982) (customer given choice between AAA, New York Stock Exchange, American Stock Exchange, Chicago Board Options Exchange or Nat'l Ass'n of Sec. Dealers).

358. As noted *infra* notes 375-76 and accompanying text, all the industry organizations from which the customer may choose have adopted the Uniform Code of Arbitration, which ensures that an investor may opt for a panel made up of a majority from outside the securities industry.

359. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 824 (10th Cir. 1978) (customer given choice between New York Stock Exchange, American Stock Exchange, and Nat'l Ass'n of Sec. Dealers); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 558 F.2d 831, 833 (7th Cir. 1977) (same).

allow the customer to choose an arbitration panel that consists of a majority from outside the industry.³⁶⁰ It simply is not true that arbitration clauses are designed to ensure that the broker always has the home team advantage.

B. DISPELLING THE MYTHS ABOUT ARBITRATION PROCEDURES

Under the rules of all the major exchanges,³⁶¹ a customer can insist that disputes with his broker be arbitrated, whether there is an agreement to that effect or not; the exchanges insist that their members arbitrate if the customer wants to arbitrate.³⁶² Thus, a compulsory arbitration clause between a customer and a broker that is applicable to both parties favors the broker by making the right to insist on arbitration reciprocal.³⁶³ Most customers and their lawyers therefore are suspicious about arbitrating disputes; they question why the brokers want arbitration if it does not give them an advantage. The answer must be that the brokers are attempting to save on the cost of litigation, which benefits both parties. This is the only reasonable explanation, because the idea that arbitration procedures unfairly benefit the broker is pure myth.

360. Each industry organization referred to *supra* note 359 has arbitration rules that so provide. See *infra* notes 375-76 and accompanying text.

361. Since 1980, the arbitration rules of the major exchanges and other SROs have been uniform. In 1979 and 1980, 10 major SROs adopted the Uniform Code of Arbitration: the New York Stock Exchange, the American Stock Exchange, the Nat'l Ass'n of Sec. Dealers, the Pacific Stock Exchange, the Municipal Securities Rulemaking Board, the Cincinnati Stock Exchange, the Midwest Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, and the Philadelphia Stock Exchange. See Katsoris, *supra* note 9, at 284 & n.24. For a discussion of the history of the development of the Uniform Code of Arbitration, see *id.* at 283-84.

362. See UNIFORM CODE OF ARBITRATION Rule 600(a) (as adopted by the New York Stock Exchange, reprinted in *Arbitration Rules*, Dep't of Arbitration, New York Stock Exchange, Inc., 11 Wall St., New York 10005) [hereinafter UNIFORM CODE OF ARBITRATION]; see also *Axelrod & Co. v. Kordich, Victor & Neufeld*, 451 F.2d 838, 841-43 (2d Cir. 1971) (stating that a member of New York Stock Exchange must abide by the Exchange's arbitration rule); *Financial House, Inc. v. Otten*, 369 F. Supp. 105, 107-08 (E.D. Mich. 1973) (member of Nat'l Ass'n of Sec. Dealers must arbitrate according to the rules of the Ass'n).

363. See Note, *supra* note 203, at 996-97. Courts have not been troubled that the exchange rules require brokers to waive their right to sue in federal court even for express claims under the 1933 Act, because it is generally assumed that the securities acts were not designed to protect brokers. See, e.g., *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213-14 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 771-72 (S.D.N.Y. 1968).

1. Myth #1: Customers are Unlikely to Win in Arbitration
Because the Procedures are Fundamentally Unfair
to Them.

Both courts³⁶⁴ and commentators³⁶⁵ have objected to arbitration on the ground that arbitration procedures favor brokers. The objection is not a valid one today for three reasons. First, as already noted, nearly all arbitration clauses permit the customer to choose to arbitrate before the American Arbitration Association.³⁶⁶ The Association is an independent, nonprofit organization with approximately 60,000 arbitrators throughout the United States and twenty six branch offices in the major American cities,³⁶⁷ so the parties need not travel long distances to conduct the arbitration hearings. The rules of the American Arbitration Association contain a number of procedural safeguards for the disputants: the arbitrators must be neutral,³⁶⁸ the parties decide on the locale of the hearing,³⁶⁹ the parties choose the arbitrators,³⁷⁰ either party may be represented by counsel,³⁷¹ and both parties may call witnesses and introduce documentary evidence.³⁷² In addition, the parties may conduct limited discovery³⁷³ and can have a complete record made of the proceedings.³⁷⁴ It is difficult to see how such rules could work to the unfair advantage of brokers.

Second, there is a high degree of solicitousness toward the customer even for arbitrations conducted before industry-sponsored panels. Contrary to the widely-held belief that arbitrators for the exchanges are biased in favor of brokers,³⁷⁵ the Uniform Code of Arbitration, which has been adopted by all the major exchanges, provides that an investor may demand an

364. *E.g.*, *Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 64 Cal. App. 3d 899, 135 Cal. Rptr. 26 (1976) (holding that arbitration agreement requiring customer to arbitrate under rules of New York Stock Exchange was unenforceable, since those rules were fundamentally unfair).

365. *See, e.g.*, Comment, *supra* note 203, at 123.

366. *See supra* notes 355-60 and accompanying text.

367. *See Meyerowitz, supra* note 7, at 79.

368. AAA Commercial Arbitration Rule 12, *reprinted in* R. COULSON, BUSINESS ARBITRATION - WHAT YOU NEED TO KNOW 86 (2d ed. 1982).

369. *Id.* (Rule 11).

370. *Id.* at 87 (Rules 13, 14).

371. *Id.* at 88 (Rule 22).

372. *Id.* at 90 (Rule 31).

373. *Id.* The issue of discovery in arbitration is discussed in more detail *infra* notes 387-98 and accompanying text.

374. AAA Commercial Arbitration Rule 23, *reprinted in* R. COULSON, *supra* note 368, at 88.

375. *See, e.g.*, Comment, *supra* note 203, at 123.

arbitration panel made up of a majority from outside the securities industry.³⁷⁶ The parties are each given one peremptory challenge and unlimited challenges for cause of the arbitrators selected.³⁷⁷ Any potential biases must be disclosed by the arbitrators³⁷⁸ and, before challenges are made, each party is informed of the business affiliations of the arbitrators.³⁷⁹ Third, customers are protected by the rules set forth in the Uniform Code of Arbitration which, like the rules of the American Arbitration Association, allows the parties to be represented by counsel,³⁸⁰ to conduct limited discovery,³⁸¹ and to request a complete record of the proceedings.³⁸² Since its adoption in 1979 and 1980, the Uniform Code of Arbitration has received the imprimatur of the courts³⁸³ and the tacit approval of the SEC.³⁸⁴

The most important indicator that arbitration before the exchanges is a fair mechanism for customers is that customers win their disputes in those arbitration proceedings. Customers won exactly half of the 410 broker-customer disputes adjudicated by arbitration before SROs in 1980.³⁸⁵ That trend continued in succeeding years, with customers winning approximately

376. See UNIFORM CODE OF ARBITRATION, *supra* note 362, Rule 607(a).

377. See *id.* Rule 609.

378. See *id.* Rule 610.

379. See *id.* Rule 608.

380. See *id.* Rule 614.

381. See *id.* Rule 619, 620.

382. See *id.* Rule 624.

383. See *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1361 (11th Cir. 1985) (stating that Code rules adequately protect rights of customers); *Brener v. Becker Paribas Inc.*, 628 F. Supp. 442, 448-49 (S.D.N.Y. 1985) (rejecting argument that Code rules do not adequately protect the rights of investors).

384. Under § 19(c) of the 1934 Act, the SEC has the power to amend, add to, delete from, or abrogate any rules of any of the exchanges if it perceives the possibility of abuse or unfairness in exchange procedures. See 15 U.S.C. § 78s (1982). Thus, if the SEC perceived unfairness in the exchanges' arbitration rules, it could void them or change them as it wished. This has led one court to the conclusion that the Code rules are fair to investors. See *Brener*, 628 F. Supp. at 448-49. The SEC now agrees. It recently argued that when arbitration is subject to SEC oversight, as it is when conducted between an investor and a registered broker-dealer, the investor is sufficiently protected and arbitration agreements should be enforced. SEC Amicus Brief, *supra* note 21, at 13. In addition, the SEC has stated its belief that arbitration is an economical and efficient means of resolving disputes between customers and their brokers. See Exchange Act Release No. 15,984, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,122, at 81,975 (July 2, 1979).

385. See *Katsoris*, *supra* note 9, at 280 n.7.

51.5 percent of the cases over a four year period.³⁸⁶

2. Myth #2: The Lack of Full Discovery in Arbitration Works to the Disadvantage of Investors.

Commentators have noted the lack of discovery in arbitration and have suggested that that puts investors at a disadvantage before arbitration panels.³⁸⁷ On close examination, however, this objection is without merit.

First, discovery is available in arbitration proceedings; it is just more limited than in full-blown litigation.³⁸⁸ The FAA empowers arbitrators to subpoena documents and persons,³⁸⁹ which in practical terms means the parties have the subpoena power subject to the arbitrator's control of abuses.³⁹⁰ In addition, the rules of both the Uniform Code of Arbitration³⁹¹ and the American Arbitration Association³⁹² provide for subpoenas to be issued at the request of either party or their attorneys. Furthermore, a court that has stayed judicial proceedings pending arbitration can order discovery if necessary to a party's case, and the discovery will not delay the arbitration proceeding.³⁹³ Thus, the only discovery the arbitration rules do not allow is abusive discovery or discovery conducted as a fishing expedition for a claimant who does not yet have a case when she files. These discovery limitations work to the benefit of both parties. A large brokerage firm cannot wear down an investor with expensive and time-consuming discovery requests, and the investor cannot harrass the broker with a strike suit to compel settlement.

In addition, investors are not disadvantaged by limited discovery because it is largely unnecessary under the arbitration

386. In 1981, customers won 264 of 532 cases; in 1982, customers won 293 of 558 cases; and in 1983, customers won 331 of 622 cases. *See id.*

387. *See, e.g.,* Neville, *supra* note 234, at 7 (noting that lack of discovery is used as an argument against enforcing arbitration agreements).

388. *See* Katsoris, *supra* note 9, at 287 & n.52, and sources cited therein.

389. *See* 9 U.S.C. § 7 (1982).

390. *See, e.g.,* Local Lodge 1746, Int'l Ass'n of Machinists v. Pratt & Whitney Div., 329 F. Supp. 283, 284 (D. Conn. 1971) (illustrating the way in which subpoena procedure under FAA works: parties submit requests for subpoenas to arbitrator and arbitrator signs the subpoenas). There is nothing to suggest that reasonable requests for discovery are ever denied by arbitrators.

391. *See* UNIFORM CODE OF ARBITRATION, *supra* note 362, Rule 619.

392. *See* AAA Commercial Arbitration Rules, *reprinted in* R. COULSON, *supra* note 368, at 85-94.

393. *See* Note, *Arbitration and Award—Discovery—Court May Permit Discovery on the Merits When It Will Not Delay Arbitration*, 44 U. CIN. L. REV. 151 (1975).

rules used by the securities exchanges. A claimant must, in the initial statement of a claim, set out all the facts on which he intends to rely.³⁹⁴ The answering party must then set out all the facts on which she will rely at the hearing and set forth all defenses that will be asserted.³⁹⁵ Any facts, claims, or defenses left out of either pleading may not be used at the hearing itself.³⁹⁶ After the pleadings have been filed, the rules require the parties to cooperate in the exchange of documents and information.³⁹⁷ Thus, at least with respect to arbitrations before the major securities exchanges, formal discovery has become largely unnecessary.

Finally, to argue against arbitrating securities disputes because of the lack of formal discovery would be to argue against arbitrating any disputes because all arbitration proceedings, not just those for securities disputes, lack formal discovery procedures. The lack of the expensive elements of litigation is what makes arbitration so attractive. As Judge Learned Hand noted more than forty years ago, efficient and inexpensive arbitration is inconsistent with all the accoutrements of litigation.³⁹⁸

3. Myth #3: The Lack of Judicial Instruction on the Law Prejudices Customers in Arbitration Proceedings.

Some courts and commentators have suggested that, in arbitration, the trier of fact's lack of judicial instruction works to the detriment of investors or otherwise diminishes the effectiveness of the arbitration alternative.³⁹⁹ That critique, like most, is one that is universally applicable: if it were a reason for not arbitrating securities disputes, it would be a reason for not arbitrating any legal disputes. Furthermore, as several observers have aptly noted, the parties are entitled to brief the arbitrators on the law and to make opening and closing arguments.⁴⁰⁰ The arbitrators, therefore, do not go without in-

394. See UNIFORM CODE OF ARBITRATION, *supra* note 362, Rule 612.

395. See *id.*

396. See *id.*

397. See *id.* Rule 619.

398. *American Almond Prods. Co. v. Consolidated Pecan Sales Co.*, 144 F.2d 448, 451 (2d Cir. 1944) (L. Hand, J.).

399. See, e.g., *Wilko v. Swan*, 346 U.S. 427, 436-37 (1953); *Neville*, *supra* note 234, at 7; cf. *Bernhardt v. Polygraphic Co.*, 350 U.S. 198, 203 (1956) (stating lack of judicial instruction as one reason the result in an arbitration may differ from the result in a judicial setting).

400. See *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1361 (11th Cir. 1985); *Sobel v. Hertz, Warner & Co.*, 469 F.2d 1211, 1215 (2d Cir. 1972); *Neville*, *supra* note 234, at 7.

struction on the law. Moreover, many arbitrators themselves are retired judges and lawyers.⁴⁰¹

Even if the arbitrators were not as fully and impartially apprised of the law as a jury would be, that shortcoming is party-neutral; there is no reason to believe it works to the advantage or disadvantage of either customers or brokers.

4. Myth #4: The Lack of Judicial Review Available for Arbitral Awards Puts the Investor at an Unfair Disadvantage.

Critics of arbitrating securities disputes often bemoan the lack of judicial review available for arbitrators' decisions, sometimes claiming that the lack of review results in a substantial diminution in investor protection.⁴⁰² The critics are at least half right: judicial review is limited if a party is unsatisfied with an arbitration award. Nevertheless, that limitation on judicial review does not work to the disadvantage of the investor.

Because binding arbitration is inconsistent with complete judicial review,⁴⁰³ courts may not review the factual and legal issues that were decided by the arbitration panel.⁴⁰⁴ Rather, the judicial role is confined to correcting extraordinary abuses of power.⁴⁰⁵ That is not to say that arbitrators are not obligated to follow the law. On the contrary, in a securities dispute, arbitrators must decide the matter in accordance with the securities laws, not just on some notion of fairness.⁴⁰⁶

Although there have been some suggestions that an arbitrator's misreading of or failure to follow applicable law would be grounds for overturning the award,⁴⁰⁷ it seems clear that the requisite abuse of power by the arbitrator to warrant overturn-

401. See Neville, *supra* 234, at 10.

402. *Id.*

403. See R. COULSON, *supra* note 368, at 25 (arbitration cannot result in quick resolution if judicial review is permitted).

404. See *Mobil Oil Corp. v. Local 8-766, Oil, Chem. & Atomic Workers Int'l Union*, 600 F.2d 322, 326 (1st Cir. 1979) (allowing judicial review only when the arbitrators have exceeded their jurisdictional powers).

405. See *id.*

406. See *Wilko v. Swan*, 346 U.S. 427, 433-34, 435 (1953); see also *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 105 S. Ct. 3346, 3355 (1985) (stating that by submitting to arbitration, parties do not give up substantive legal rights). But see Comment, *supra* note 203, at 123 (suggesting that the arbitrator's duty to follow substantive law is vague).

407. See, e.g., *Wilko v. Swan*, 346 U.S. 427, 440 (1953) (Frankfurter, J., dissenting); *In re Revenue Properties Litig. Cases*, 451 F.2d 310, 314 (1st Cir. 1971).

ing an award is much more than a simple error of law. Section 10 of the FAA lists four grounds on which an arbitration award may be vacated: if the award was procured by "corruption, fraud, or undue means";⁴⁰⁸ if the arbitrators were guilty of "evident partiality or corruption";⁴⁰⁹ if the arbitrators were guilty of misconduct that prejudiced a party;⁴¹⁰ or if the arbitrators exceeded their powers or so imperfectly executed them that a final and definite award was not made.⁴¹¹ The Supreme Court has interpreted section 10 to include cases in which the arbitrators exhibited a "manifest disregard" of the law, apparently because such disregard constitutes misconduct on the part of the arbitrators given their duty to follow the law.⁴¹² Courts now recognize that the grounds for overturning an arbitration award are limited to the four express grounds provided in the FAA and the "manifest disregard" standard implied by the Supreme Court.⁴¹³

Not surprisingly, arbitration review cases tend to focus on the question of manifest disregard of the applicable law. Courts will not vacate an arbitral award for mistakes of law made by the arbitrators unless, as a general rule, there is some indication that the arbitrators knew what the applicable law was and simply ignored it or refused to apply it.⁴¹⁴ Because arbitrators

408. 9 U.S.C. § 10(a) (1982).

409. *Id.* § 10(b).

410. *See id.* § 10(c).

411. *See id.* § 10(d).

412. *See Wilko*, 346 U.S. at 436-37 (distinguishing faulty interpretations of the law from manifest disregard). Lower courts have followed the Supreme Court's lead by recognizing manifest disregard of the law as a grounds for overturning an arbitral award. *See, e.g., San Martine Compania De Navegacion, S.A. v. Saguenay Terminals, Ltd.*, 293 F.2d 796, 801 (9th Cir. 1961); *Fairchild & Co. v. Richmond, Fredericksburg & Potomac R.R.*, 516 F. Supp. 1305, 1315 (D.D.C. 1981).

413. *See, e.g., Peters Fabrics, Inc. v. Jantzen, Inc.*, 582 F. Supp. 1287, 1292 (S.D.N.Y. 1984) (applying 9 U.S.C. § 10(c) when stating the grounds on which an arbitration award can be vacated).

414. *See Local No. P-1236, Amalgamated Meat Cutters v. Jones Dairy Farm*, 680 F.2d 1142, 1144 (7th Cir. 1982) (holding that a court lacks authority to overturn an arbitration award unless arbitrator showed a manifest disregard for the law); *Sobel v. Hertz, Warner & Co.*, 469 F.2d 1211, 1214 (2d Cir. 1972) (arbitrators must have ignored the applicable law); *San Martine Compania De Navegacion, S.A.*, 293 F.2d at 801 (manifest disregard may exist where the arbitrators understood and correctly stated the law but disregarded it nonetheless); *Fairchild & Co.*, 516 F. Supp. at 1315 (arbitrators must have correctly stated the law and disregarded it); *Sidarma Societa Italiana Di Armamento Spa, Venice v. Holt Marine Indus.*, 515 F. Supp. 1302, 1308-09 (S.D.N.Y.) (arbitrators must have deliberately disregarded what they knew to be the law), *aff'd*, 681 F.2d 802 (2d Cir. 1981); *Fukaya Trading Co. v. Eastern Marine Corp.*,

are not required to give reasons for their decisions⁴¹⁵ and, indeed, are discouraged from doing so,⁴¹⁶ some commentators question how a dissatisfied arbitrator can challenge the award on the basis of a manifest disregard of the law.⁴¹⁷

The answer is that a court *will* be able to discern obvious, grotesque disregard of the law, because the record will include the parties' detailed submissions to the arbitrators, including memoranda of law,⁴¹⁸ together with all the documents involved in the case and a transcript of the hearing if the parties so desire.⁴¹⁹ Thus, if the parties' memoranda and remarks before the arbitrators indicate agreement on a point of law, and the award is patently inconsistent with that law, a court must infer that the arbitrator was aware of the law and disregarded it. Similarly, if the arbitrator's remarks in the transcript indicate a determination to disregard the applicable law, the court would be forced to overturn the award. Even if some mistakes of law cannot be corrected, however, that is not necessarily a disadvantage for the investor. The entire judicial review process is party-neutral in that it does not favor one side or the other. Either party can be victimized by an arbitrator's error of law, just as either party can be victimized by a court's or jury's error of law.

Perhaps most important, however, is that certain limitations, such as the possibility that an arbitration panel will misapply the law without being corrected, are inherent in the nature of arbitration. The problem of judicial review cannot be used to argue against arbitrating securities claims, because to do so would be to argue against arbitrating any claims the parties have agreed to arbitrate.⁴²⁰ Congress decided that matter of

322 F. Supp. 278, 282 (E.D. La. 1971) (holding that an arbitration award will be vacated only if the award was made in manifest disregard of the law). *But see In re Revenue Properties Litig. Cases*, 451 F.2d 310, 314 (1st Cir. 1971) (stating that "any manifest misreading of securities legislation can be effectively challenged in court").

415. *See Sobel*, 469 F.2d at 1214.

416. *See R. COULSON*, *supra* note 368, at 25 (AAA does not encourage written opinions by arbitrators).

417. Some courts have noted this conundrum as a shortcoming of arbitration. *See, e.g., Wilko v. Swan*, 346 U.S. 427, 436-37 (1953); *Sobel*, 469 F.2d at 1214.

418. *See Sobel*, 469 F.2d at 1215.

419. *See, e.g., Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352, 1361 (11th Cir. 1985).

420. *See, e.g., In re Revenue Properties Litig. Cases*, 451 F.2d 310, 313-14 (1st Cir. 1971) (stating that arbitration cannot be insulated from important issues of substantive law); *Fallick v. Kehr*, 369 F.2d 899, 903 (2d Cir. 1966) (stat-

policy in 1925 when it enacted the FAA: Arbitration clauses are to be enforced because arbitration is a good thing.

CONCLUSION

Privatization of disputes through arbitration is a good thing, particularly for securities disputes. Its advantages accrue equally to both investors and brokers. The parties have an opportunity to avoid crowded court dockets in favor of a resolution procedure whose average total time is from four to six months.⁴²¹ Reduced resolution times can be particularly advantageous to plaintiffs with valid claims because they will receive payment sooner. The time element benefits both parties by ensuring that evidence will be fresh.

Arbitration is also considerably cheaper than litigation—about one-third the cost, even taking into consideration that both parties may be represented by counsel.⁴²² Therefore, smaller claims that an investor could not assert in court due to the expense of litigation may be vindicated in arbitration. In fact, both the American Arbitration Association and the Uniform Code of Arbitration provide streamlined procedures for small claims.⁴²³

The parties are not the only beneficiaries of privatization. Arbitration promotes important societal interests as well. Because of the crowded court dockets, for every claim that is litigated, another is left waiting. Thus, to the extent more cases go to arbitration, more claimants who may not have agreed to arbitrate their claims will have access to the federal courts. In addition, the unnecessary litigation of cases in federal court carries with it enormous dollar costs for society as a whole. The country's resources are better spent elsewhere.

Arbitration cannot possibly retain its advantages and have all the niceties a judicial hearing entails, but that is something for the parties to consider before they enter into arbitration agreements.⁴²⁴ With respect to securities agreements, all the

ing that it is unavoidable that arbitration will frequently decide difficult issues of law); Sterk, *supra* note 95, at 516-17 (stating that there is no persuasive reason for treating securities law cases differently than other cases with respect to the possibility of error of law in arbitration).

421. See Meyerowitz, *supra* note 7, at 80.

422. See *id.*

423. See AAA Commercial Arbitration Rules 54-58, reprinted in R. COULSON, *supra* note 368, at 93-94; UNIFORM CODE OF ARBITRATION, *supra* note 362, Rule 601.

424. See *American Almond Prods. Co. v. Consolidated Pecan Sales Co.*, 144

evidence indicates that at the time the agreement is signed, customers have a choice as to whether they want to arbitrate future disputes with their broker.⁴²⁵

With those thoughts in mind, the courts and Congress can promote the privatization of securities disputes in a number of ways. The decision in *Wilko v. Swan*⁴²⁶ should be overturned by the Supreme Court or by Congress. The case was wrongly decided as a matter of statutory interpretation, and its holding is bad policy. The SEC now also argues for its demise.⁴²⁷ No valid reasons justify barring investors from agreeing to arbitrate future disputes that arise under the express liability provisions of the 1933 Act. To the extent that parties seeking to avoid their contractual obligations to arbitrate entered into the agreements knowingly and willingly, the courts should have no sympathy for them; to the extent those parties' agreements were not willful and knowing, the parties' recourse should be to principles of contract law as contemplated by the FAA.⁴²⁸

If *Wilko* is not overturned, courts should adopt the sophisticated investor exception more widely.⁴²⁹ The government enacted the securities laws for the benefit of people who could not look out for themselves.⁴³⁰ The government should not provide an escape hatch from contracts for parties who need no assistance from the government. In addition, the *Wilko* doctrine should not be extended to claims that arise under the 1934 Act or to claims under implied causes of action generally. Even assuming *Wilko* was rightly decided, there is no analytical reason for applying its holding to these other types of claims.⁴³¹ Any further limitation on the enforcement of valid arbitration clauses is just plain bad policy.

Finally, as Lord Hewart wrote more than sixty years ago,

F.2d 448, 451 (2d Cir. 1944) (L. Hand, J.) (stating that when parties adopt arbitration, "they must be content with its informalities; they may not hedge it about with those procedural limitations which it is precisely its purpose to avoid").

425. See *supra* notes 337-52 and accompanying text.

426. 346 U.S. 427 (1953).

427. See SEC Amicus Brief, *supra* note 21, at 13 ("The view of arbitration on which *Wilko* rested is today inappropriate in cases involving disputes between registered broker-dealers and their customers.").

428. See 9 U.S.C. § 2 (1982).

429. See *supra* notes 234-53 and accompanying text.

430. See, e.g., *Coenen v. R.W. Pressprich & Co.*, 453 F.2d 1209, 1213-14 (2d Cir.), *cert. denied*, 406 U.S. 949 (1972); *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 772 (S.D.N.Y. 1968).

431. See *supra* notes 273-313 and accompanying text.

"[i]t is not of some importance but is of fundamental importance that justice should not only be done, but should manifestly and undoubtedly be seen to be done."⁴³² This Article has demonstrated that in arbitration justice is done, or at least that its possibility is procedurally maximized. Securities regulation is concerned with investor confidence,⁴³³ however, and no system of dispute resolution is acceptable if it is not perceived to be fair. The securities industry should therefore remedy, with aggressive public relations work, the disparity between the perception of fairness and the fact of fairness in the arbitration of securities disputes. With its enhanced image, privatization may then gain the good reputation it deserves.

432. *King v. Sussex Justices*, [1924] 1 K.B. 256, 259.

433. *See Sterk, supra* note 95, at 519.